

# Bankruptcy Law

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**Sponsored by the Justice and Legal System Research Institute**

**2009**



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## GENERAL INTRODUCTION

Persons could not be always financially self-sufficient. Sometimes it happens that persons enter into different transactions either on cash basis or on credit basis. It is common that persons enter into transactions as a result of which one becomes a creditor and the other a debtor. Where there is such a relationship, the relationship has to be settled by a legal device when one of them fails to discharge his her obligation.

Because of certain reasons, the debtor may refuse or fail to pay the debt he owes from the creditor. If creditor is left without any remedy in case where the debtor defaults to pay the debt, it would have a repercussion on the relationship among the members of the society. In the old times, there were certain measures to be taken by the creditor against the debtor. It was common that in earlier times the debtor is mutilated, arrested, etc where he defaults to pay the debt to the creditor. These measures were found to be appropriate in those times given the then level of development of the society. These and other measures later proved to be outdated as the society continued to develop from time to time.

Instead of the traditional measures, developed and up-to-date mechanisms were devised. One of the important mechanisms is the one that regulated the relationship by a legal device such as the law of bankruptcy. The law of bankruptcy is a legal mechanism to settle the relationship between the creditor and the debtor as opposed to the above-mentioned traditional systems. This course is about a legal device of settling commercial relationship between the debtor and creditor.

The course is divided into seven chapters including the introductory part. After the introductory chapter, is the judgment of bankruptcy and its effects. Will be discussed by highlighting particularly the procedures and requirements for the debtor to be adjudged bankrupt and the effects to follow the adjudication of bankruptcy of the debtor. The effects could be as regards the debtor himself, the creditors or third parties. The third chapter will deal with the persons responsible to carry out the bankruptcy proceeding. In

this chapter we will mainly discuss the powers and functions of the court, the commissioner and other persons responsible to carry out the bankruptcy proceedings. The fourth chapter is on the measures in relation to the assets of the debtor. In this chapter our focus will be on the conservatory and provisional measures to be taken, such as affixing seal, making inventory and the like; so that the assets of the debtor are to be kept properly. The fifth chapter is going to deal with proof of debts. In order to participate in a bankruptcy proceeding as a creditor, one has to prove his claim before the appropriate body. The six chapter deals with the winding up and closure of the bankruptcy proceeding. After all the properties of the debtor are identified, they have to be realized for the benefit of the creditors and the process of bankruptcy closes after distribution of the proceeds. The last chapter is on schemes of arrangement. In that part we are going to discuss the procedures and requirements for proposal and approval of the schemes of arrangement.

# CHAPTER ONE

## INTRODUCTION TO BANKRUPTCY

### **Introduction**

The concept of bankruptcy is one of the difficult issues for it is not common in the practice of courts in our country. It is only recently that the course started to be offered to students in universities and colleges. Currently, only few of the higher educational institutions included the course in their curriculum. Before one goes into the details of bankruptcy, it is important to get acquainted with the historical background as well as the meaning of bankruptcy. In this Unit therefore, we are going to discuss the historical background, meaning, and basic principles of bankruptcy.

The Unit is divided into six sections. The first section is on the historical background of bankruptcy. In this section, we will mainly discuss the historical background in the world and in Ethiopia particularly. The second section will deal with the meaning of bankruptcy. In this section we will discuss the different possible meanings of bankruptcy and the definition of the concept under the Ethiopian Commercial Code. The third section is on the scope of the law of bankruptcy. In this section the focus will be on the subjects of the law of bankruptcy and the jurisdiction of courts. The provisions of other laws than the bankruptcy law will also be discussed under this section. The fourth section will deal with the cardinal principles of bankruptcy. In this section we will discuss the important and general principles governing the law of bankruptcy in various countries of the world. The fifth section is on comparison between bankruptcy and winding up. In this section we will focus on the points of similarity and difference between bankruptcy and winding up. The sixth and last section is on the conditions of bankruptcy. In this section the focus will be on the conditions that must exist for the existence of bankruptcy.

## Objectives

At the end of this chapter you should be able to:

- discuss the historical background of bankruptcy;
- define the concept of bankruptcy;
- distinguish the scope of bankruptcy under Ethiopian Law;
- enumerate the cardinal principles of bankruptcy;
- apply the different principles to different practical cases;
- compare and contrast bankruptcy and winding up, and
- identify the conditions of bankruptcy.

### 1.1. Bankruptcy: Defined

It is proper to define the term bankruptcy before delving into the discussion on the concept. Some literatures reveal that the term bankruptcy is used only for individual debtor's insolvency whereas the term liquidation is used for insolvency of business organization. However, many jurisdictions use the term bankruptcy interchangeably with insolvency and some times use bankruptcy as general term applied for natural as well as for legal persons.

Let us see the dictionary definition. A Dictionary of Modern Legal Usage traces the origin of the term and then defines it. It begins with shading light from where the term was coined and hence Bankruptcy in French or Latin *bancus* "table" plus *ruptus* "broken". This is literally to mean 'broken table', and then extended the three definitions as follows:

- the fact of being financially unable to pursue one's business and meet one's engagements;
- the fact of having declared bankrupt under a bankruptcy statute;
- the field of law dealing with those who are unable or unwilling to pay their debts.

Some other literatures provide various accountancy definitions for the term insolvency. These are:

### **Balance-sheet insolvency**

This has regard to the person's assets and liabilities, and looks to see whether there is an overall net surplus or deficit. Under this definition, if assets minus liability show deficit (negative) that person is insolvent.

### **Commercial insolvency**

This test is not concerned with the assets position, but with liquidity. It is some times called practical insolvency or insolvency on a cash-flow basis. Here, the person concerned may have substantial assets, but is unable to pay his debts as they fall due. This would happen when the wealth is tied up in property that is not readily realizable or which is over-spent in research and development for a new project, which is still on the drawing board.

### **Ultimate insolvency**

Here, the concern is with the final outcome of the events. The debtor's assets have been sold for a value that is found appropriate given the prevailing state of affairs. In other words, the assets are to be sold for what they will fetch. Perhaps in a forced state, on a break-up basis the costs of realization and of administering the estate are taken into account.

It has been stated above, there are a lot of disparities among scholars and academicians with respect to the definition of bankruptcy. In any case, when these definitions are condensed to a conventionally acceptable definition, one can draw, possibly, two fundamental working definitions. These are: Bankruptcy is status of a person who has been made the subject of the application of bankruptcy law and who has been declared as

bankrupt by a court of law. Bankruptcy is a situation whereby a person by his acts and conducts affords evidence of his inability to pay or his intention to avoid payment of his debts.

Little to say about the working definitions; in the first case it shows that the adjudication of a debtor as bankrupt in the competent court of law which has power to do so when the legal requirements are satisfied. The adjudication can be initiated by the interested parties as the laws of various jurisdictions may provide. The second definition reveals the conduct or acts of the debtor must show his unwillingness to pay his debts due. To exemplify this, the creditor may provide to the debtor execution order which he obtained from the court of law and he may fail to get payment from the debtor. In addition, criminal charge may be filed against the debtor for his fraudulent conduct as per criminal code for his tendency to defraud and this can also be a condition to evidence his conduct. The intention of the debtor could also be disclosed when he absconds and his whereabouts is not known.

It has been said that the terms insolvency and bankruptcy are interchangeably used in many literatures. However, one could be misled by the terms. To make distinction between the terms is of no importance for practical purpose. But for better understanding and academic purpose it is possible to draw distinction. Hence, with some reservation one can say, insolvency presupposes bankruptcy or bankruptcy is an outcome of insolvency. It is also possible to draw another distinction and one can also say that all insolvencies may not lead to bankruptcy and all bankruptcies are not an outcome of insolvency. This is because the course of business does not depend on solvency. If there is sufficient liquidity, a debtor can discharge his debts running his business on credit basis. A business may be prevented from paying creditors and still have more assets than liabilities. However, if it lacks liquidity then it is deemed to be in a state of bankruptcy. Liquidity is the status or condition of a person or a business in terms of his or its ability to convert assets into cash. It is the degree to which an asset can be acquired or disposed of without danger of intervening loss in nominal value.

## **Definition of Bankruptcy under the Ethiopian Commercial Code**

Book V of the Commercial Code under Article 969 and 970 defines, as to what bankruptcy is, in two different ways. As a principle, under Article 970 (1) the Code states that bankruptcy shall not result from mere suspension of payments, unless a judgment in bankruptcy is given or factual conditions are fulfilled in the way the law requires. The two situations provided to define bankruptcy are stated as follows: *First*, “Any trader who has suspended payments and has been declared bankrupt shall be deemed to be bankrupt.” *Second*, a sentence passed by a criminal court in respect of bankruptcy or any offence connected with bankruptcy notwithstanding that suspension of payments has not been established by a judgment in bankruptcy shall be deemed to be bankruptcy of fact (emphasis added Article 970 (2) of the Commercial Code).

The first definitional provision indicates declaration of bankruptcy through judgment by competent court after investigation. To declare someone as bankrupt the main test is suspension of payments. This can be called judicial bankruptcy or legal bankruptcy. The second definition envisages the factual bankruptcy. In this case criminal court may pass sentence on the debtor even though suspension of payment is not proved by court as alleged by interested party. The offence under which the debtor is sentenced shall be connected with bankruptcy or in respect of bankruptcy.

What kind of offences are connected with bankruptcy or, in respect of bankruptcy, would be point of discussion to make the second definition more understandable? In this regard it is proper to refer to the Penal Code of Ethiopian. The 1957 Penal Code of Ethiopia provides ten provisions under Book VI Title II Chapter II. of The heading of this chapter reads "Offences Relating to Proceedings of Debt, Execution and Bankruptcy". For instance, if we see Article 683 within the same chapter; "a debtor subject to proceedings by way of execution against whom a declaration of default has been delivered, and who with intent to prejudice his creditors has reduced his assets, whether materially or fictitiously, is punishable with a simple imprisonment or in grave cases, with rigorous imprisonment not exceeding five years." Also as provided under Article 684, if a debtor

misappropriates or destructs property subject to pledge or lien to obtain profit or to procure a benefit to third party, or to cause damage to his creditors he will be punished. Hence, as exemplified, any debtor found guilty of related offences and sentenced, even though there is no proof of suspension of payment, the person is deemed to be under factual bankruptcy. The rationale behind this definitional provision could be to save the creditors from further damage and to secure their rights on the immediately existing properties.

## **1.2. Evolution of the Law of Bankruptcy**

Bankruptcy law governs the rights of creditors, on the one hand and that of an insolvent debtor, who cannot pay his debts, on the other hand. The term was derived from the Renaissance custom of Italian traders, who did their trading on benches in town market places. Creditors literally "break the bench" of a merchant who fails to pay his debts. The term *bancarotta* (broken bench) thus came to apply to business failures.

Default or non-payment of debt has long been an essential feature of a system of promise enforcement, centuries before bankruptcy law became integral part of the collection scheme. The Holy Scripture (Bible) has the following evidence:

*"At the end of every seven years you must cancel debts. This is how it is to be done: every creditor shall cancel the loan he has made to his fellow Israelite. He shall not because the Lord's time for canceling debts has been proclaimed. You may require payments from foreigners, but you must cancel any debt your brother owes you. However, there should be no poor among you." Deuteronomy 15:1-4*

This Biblical Jubilee shows society's past attempt to balance rightful demands for payments with some possibility of escape. Closer reading of the scripture illuminates that there was cancellation of debts and discharge of debtor when he/she happened to be poor or unable to pay debt at the end of each seven years.

The medieval Italian cities enacted statues dealing with the collection and distribution of the assets of a debtor, especially merchants, who absconded or fraudulently caused insolvency. Life for the medieval debtor was likely to be nasty, brutish and short. Just as the charging of usury by money lenders was regarded as contrary to the laws of God, and was punishable according to both the church and the power temporal so also was falling into debt considered moral sin. In addition, medieval Spanish law restored the judicial cession bonorum, which is an ancient Roman law by which privilege given to debtors to alleviate his hardship by relinquishing voluntarily his assets to his creditors by petitioning a magistrate. The *Siete Partidas*, a codification published by authority of Don Alfonso X the wise king of Castile and Leona, during the second half of the 13<sup>th</sup> century, contained detailed provisions relating to insolvent debtors, applicable to merchants and non-merchants. The *Siete Partidas* is a Spanish Law which is the most important monumental code that was influenced by Roman and Canon law and by the customs of Castile.

Laws dealing with the property of absconding and fraudulent debtor, modeled after the statute of medieval Italian cities spread through out Western Europe. Provisions of this type were adopted in the commercial centers of France, Brabant, and Flanders during the 15<sup>th</sup> and 16<sup>th</sup> centuries. Emperor Charles V, as count of Flanders, inserted stringent provisions for the repression of bankruptcies in his Decree for the administration of justice and good order in 1531. But these were measures designed for the protection of the individual creditors; more than 250 years were to elapse before the notion took hold of official collection and realization of a debtor's estate for the purpose of distribution among his creditors generally. This was introduced in the Statute of Henry VIII (1542), which is the first bankruptcy statute to be enacted in England. As literature reveals, this statute was not a measure designed for the relief of debtors but was inspired by the Northern European models and entirely pro-creditors.

In France, national rules on insolvency and bankruptcy were inserted into the *Ordonnance du Commerce* of 1673. The rules regulated both voluntary assignments for the benefit of creditors made by indebted merchants and the proceedings, and effects following from

bankruptcy. It was interpreted to restrict bankruptcy proceedings to merchants only, and laws of many other countries followed the French lead. Thus, in Spain the limitation of bankruptcy to merchants was adopted by the ordinance of Bilbao, which were sanctioned in 1737 and subsequently applied in Latin American countries, especially in Argentina.

As has been said earlier, ancient legislations were entirely restricted to persons engaged in commerce. The restriction of bankruptcy legislations to persons engaged in commerce created a need for liquidation proceedings applicable to other debtors. On that basis, a Spanish jurist of the 17<sup>th</sup> C, Salgado de Somoza, elaborated detailed rules for the initiation and conduct of voluntary liquidation proceeding which were "concourse of creditors" or a suit or remedy to enable creditors to enforce their claims against an insolvent or failing debtor. His tract, entitled *Labyrinthus Creditorum*, influenced the course of Spanish law and also had great impact on the common law of the German States. As a result, Spanish law developed two classes of liquidation proceedings, one for merchants and the other for non-merchants. Spanish law in that respect was the model for the legislation in Portugal, Argentina, Brazil and other Latin American countries. Other nations, including Australia, Germany, England, the United States and nations influenced by English law brought the case of both merchants and non-merchants under their bankruptcy laws.

Around the 19<sup>th</sup> C, as time went on, the trend against debtor who fails to pay his debt was changed. Another assumption came into play, which was that the debtor could be honest but unfortunate. And hence, bankruptcy laws should widen their umbrellas not only to creditors but also should direct the focus of their concern to relieving the honest debtor from the burden of oppressive indebtedness and permitting him a fresh start. This is in effect freeing him from obligations and responsibilities consequent up on business misfortune which he can not satisfy by his own efforts. Thus, the already existing legalistic approach was abandoned in favour of the economic approach aiming at debtor's rehabilitation and corporate reorganizations. In recent times, however, a great effort has been made to remove the disgrace attached to bankruptcy. Even the terms 'bankrupt' and 'bankruptcy' (or their equivalents in other languages) are less used and less frequent in

the statutory languages. Modern French Legislations, for example, totally suppress the traditional term “*faillite*” for liquidation proceedings and restrict it to special procedures entailing the imposition of disqualifications on insolvents guilty of commercial misconduct.

### **Sources and Historical Development of Ethiopian Bankruptcy Law**

Elders witness that in Ethiopia the ancient society experienced similar practices like that of Romans. In the earlier times failure to perform promises (i.e. failure to pay back loans) which were given in monetary form or in exchange of goods for goods or bartering entails punishment. The punishment imposed on defaulting persons was either imprisonment in the home of the creditor or enslavement. This trend gradually abolished during the reign of His Imperial Majesty Haile Sellasie. Before Hailesellasie's regime, Menilik II officially prohibited slavery but it hiddenly existed until mid of the 19<sup>th</sup> C.

Like all other legislations, commercial legislations probably began to play important role in Ethiopia under Menilik II and developed particularly during the reign as Regent and Emperor of His Imperial Majesty Haile Sellasie I. Scholars witnessed that there was no complete record and documentation as what was promulgated and what the contents of the legislation convey. Together with other proclamations there appears to have been bankruptcy law, which was promulgated in 1933 inspired by the French law. It was said that the said law was published in French and Amharic languages which holds about 96 Articles. The French text bears the date of "12 July 1933" but the printed Amharic text leaves the space for the date blank. M. Marein noted that there was no unanimity of opinion as to whether the so called Bankruptcy law was draft only or whether it was ever promulgated. One of the drafters of the Commercial Code, J. Escara in his *avante project 'de code de commerce'* stated that it was only draft law. This is clear indicator of the fact that there was a law dealing with bankruptcy before the coming into existence of the Commercial Code, which is currently in force.

The second half of the 19<sup>th</sup> C. in Africa as a whole and in Ethiopia particularly had unforgettable history with marked change in the laws. It was during this time that the existing laws including the Commercial Code came to existence. With regard to its source the 1960 Commercial Code is somewhat eclectic. The then drafters noted that:

*all traders buy in order to resell, all enter into contract whether of sale, agency, or carriage, and all use forms of banking credits. Bill of exchange, share companies, private limited companies, bankruptcy and other collective procedures of liquidating the goods of a trader are all institutions known almost every where. Thus, to use comparative law as an element of legislative policy is less dangerous in commercial matters than in the domain of pure civil law*

However, there are indefinable differences in the continental law approach and common law approach in areas like persons subject to bankruptcy, number and nature of procedure, effect of bankruptcy on debtor, judges' role in the proceeding, freedom left to creditors, intervention of administrative authority and defining circumstance under which a person could be declared bankrupt.

J. Escara also noted in his *avante project* and in the discussions before the sub-commission, that some of the differences are negligible. To exemplify, whether the circumstance under which a person can be declared bankrupt are defined in generic terms or enumerative list which does not create difference. This is because the general definition itself incorporates the limitative enumerative list. He conducted delicate selection of principles from different sources. Hence, in practice the Latin and Germanic institutions are the sources of the continental principles of the Ethiopian Commercial Code. But the existence of Anglo-American commercial practice and on the other hand, the excellent solutions furnished on more than one point by the written commercial law of England and the United States has also contributed to the Ethiopian law. Hence, the source and development of Ethiopian bankruptcy law has similar history with many other

countries and it cannot be traced to a single country as a source or limited legal family as the only source.

### **1.3. The Scope of law of Bankruptcy in Ethiopian Legal System**

An important question to be answered here is as to whom does the bankruptcy proceeding apply. In other words, who are the subjects of bankruptcy proceeding? Have you tried to answer the question? If so, that is great.

As we have discussed earlier in the part dealing with the historical background of bankruptcy, in the earlier times bankruptcy applies to persons who involved in commercial activities. That is to say, it is only persons who involved in commerce that can be the subjects of bankruptcy. But later, because of the influence of Spanish law, persons who did not engage in non-commercial activities were made the subjects of bankruptcy proceedings.

Do you agree that the bankruptcy proceeding applies to all citizens of the country who failed to pay debts to their creditors? I hope your answer would be “No”. If you answered so, that is great. Assume that one of the distance learners of the Alpha University College (Ato Messay) borrowed 50,000 Birr from you. He has never carried out commercial activity. After you made repeated requests to get the loan paid, he refused because of different reasons. In this case, do you think that you can apply to the court demanding the student to be declared bankrupt? Did you answer “No”? If so you are correct. As far as the scope of application of bankruptcy proceeding in our country is concerned, Ato Messay would not be declared bankrupt. Then, the question remains as to who is the subject of the bankruptcy law.

Assume that in the above given hypothetical case, Ato Messay is a businessman who carries on one or more of the activities enumerated under Article 5 of the Commercial Code. Do you agree that Messay should be declared bankrupt in case he is not in a position to pay the debt he owes to you? I am sure that your answer will be “Yes”. If you

answered so, you are correct. Being a trader, within the meaning of Article 5 of the Commercial Code, Ato Messay would be declared bankrupt. What then follows is that one of the subjects of the bankruptcy proceeding is a trader. It has, however, to be noted that the person should carry on one or more of those activities professionally and for the purpose of earning profit out of such activity to be taken as a trader.

Do you agree that business organizations are also the subjects of the bankruptcy proceeding? If you answered “No”, it is not correct. All commercial business organizations, except joint ventures, are the subjects of bankruptcy. The commercial business organizations are defined in different ways as per the provisions of the Commercial Code. Article 10 of the said Code defines based on the objectives and nature of the business organization. Based on the objective, every business organization established with the objective of carrying out one or more of the activities enumerated under Article 5 of the same Code are commercial business organizations. Based on the nature, a share company is always a commercial business organization. A share company, even if it is formed to carry out an activity different from those enumerated under Article 5, shall always be commercial business organization and therefore is the subject of bankruptcy proceedings.

On the other hand, Article 213 of the Commercial Code recognizes all business organizations, except ordinary partnerships, to be commercial business organizations. In spite of that, Article 968 makes all commercial business organizations, except joint ventures, the subjects of bankruptcy proceeding. The notion of commercial business organization is as it is defined by the provisions of Article 10 of the Commercial Code and not otherwise. Therefore, it follows that even if an ordinary partnership is not a commercial business organization within the meaning of Article 213 of the Commercial Code, it is the subject of bankruptcy proceeding as per the provisions of Article 968 of the Commercial Code.

From the discussion made above, it is clear that the scope of bankruptcy applies to any trader, within the meaning of Article 5, and any commercial business organization within

the meaning of Article 10, with the exception of joint venture. This can be understood from the provisions of Article 968 of the Commercial Code, which reads as follows:

*Art. 968- Scope of application*

- (1) The provisions of this Book shall apply to ***any trader*** within the meaning of Art 5 of this Code and to ***any commercial business organization*** within the meaning of Art. 10 of this Code with the exception of joint ventures.
- (2) Without prejudice to such provisions as are applicable to physical persons only or to the provisions of Title VI applicable to business organizations only, the provisions of Titles I, II, and V of this Book shall apply to traders and commercial business organizations.

Do you agree that the state as a legal person could be declared bankrupt? I am sure that your answer will be “No”. If you answered otherwise, that is wrong. As you know, the state acts in two different capacities. It acts in both public and private capacities. In its public capacity the state represents the public at large and discharges different functions. It is expected to defend the country against foreign aggression, maintain peace and order of the society, and provide public goods and services. In this capacity, it is not for the purpose of earning profit out of its activities but only to serve the interests of the society. But in its private capacity the state can involve in any kind of business that can bring about profit like any individual businessman.

One of the points of difference between the public finance and private finance is that while the government can stay for a long period of time with a deficit financing, the private cannot do so. The fact that there is deficit financing should not lead us to conclude that the state should be declared bankrupt if it is found that it could not pay all its debts in a given year. Normally, it would not be proper to think about bankruptcy of the state in its public capacity. This is mainly because its function is different from commercial activities and the state by its nature is eternal (even if governments may

change from time to time, the state exists forever so long as there is society). Since it is not a trader or business organization, we cannot think of bankruptcy of the state.

As regards the private capacity of the state, it can carry out one or more of the activities under Article 5 of the Commercial Code. In that case, the state is to be bound by the laws and regulations governing the different private entities that have legal personality. Just like any trader or business organization, the firm that belongs to the state could be declared bankrupt and therefore be made the subject of bankruptcy. As they have distinct personality and different objectives, bankruptcy of a given state-owned enterprise or company does not amount to bankruptcy of the state in its public capacity. For example, the Commercial Bank of Ethiopia is a share company owned by the state. Here the state acts in its private capacity. In case the bank could not pay its debts to the creditors, it could be declared bankrupt and made the subject of the bankruptcy proceeding. In that case, we could not say that the state went bankrupt.

Another important issue that needs to be addressed as regards the scope of bankruptcy is as to what aspects of a person could be basis for the declaration of bankruptcy. In other words, can declaration of bankruptcy arise from all matters of a given person? The trader can have matters falling outside his commercial activities. While he keeps books of account as regards matters falling within his commercial activities, he does not keep book of account for other matters that do not relate to the former. In case, he fails to pay debts related to matters other than his commercial activity. Do you think that he should be declared bankrupt? I hope your answer will be “No”. If that is so, you are correct. The ground for declaration of bankruptcy should be failure to pay debts related to the commercial activities of the debtor. You can read the last phrase of Article 971 of the Commercial Code, which reads as:

Art. 971- *Facts constituting suspension of payments*

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

## **1.4. Principles of Bankruptcy**

### **1.4.1. Cardinal Principles**

The cardinal principles are general principles from which all the subsidiary rules and principles of bankruptcy emanate. They are like constitutional principles from which all the bye-laws originate.

#### **Principle I: Pre-liquidation rights shall be respected:**

All the rights of individuals who acquired a right against the debtor before the latter is declared bankrupt shall be respected. Even if the debtor is declared bankrupt, the person who acquired a right before the date of declaration of such bankruptcy should not be affected. In other words, the fact that the debtor is declared bankrupt should not affect the rights of a person who is already entitled to a right before the date of declaration of bankruptcy. The person could be either the creditor of the debtor or otherwise. Declaration of bankruptcy does not affect the rights and remedies of those who own property in the possession of the debtor or who hold a security interest over all or any of his assets. For instance, assume that Ato Mogese is a debtor who failed to pay the debt he owes to his creditors. Because of fulfillment of the requirements, Ato Mogese was declared bankrupt on September 5, 2004. On August 5, 2004 Ato Mogese sold his car to W/ro Ayalnesh. The title of document was not handed over to W/ro Ayalnesh till the date of declaration of bankruptcy of Ato Mogese. In this case, even if the title of document is not yet transferred to W/ro Ayalnesh on the date of declaration of bankruptcy of Ato Mogese, the right of the former over the car would not be affected. W/ro Ayalnesh acquired the right on the date of conclusion of the contract of sale of the car. Therefore, it would not be legal to refuse to transfer the car to the buyer because of the fact that the seller is declared bankrupt before transferring the car.

Do you think that the above discussed principle is without exception? I am sure that your answer would be “No”. If you answered so, it is correct. You see, there are two important exceptions to the principle. The *first* is the case of undervalued transaction. Even if the third party has acquired the right before the date of declaration of bankruptcy of the debtor, where the right is acquired as a result of undervalued transaction, then the right shall not be respected. For example, assume that Ato Bogale is a debtor who could not pay his debts towards his creditors and as a result declared bankrupt on October 10, 2004. A month before the date of the declaration of bankruptcy, Ato Bogale sold his machinery to W/ro Meselech. The machinery was one he was using in his factory for the production of goods for sale. The market price of the machinery was 80,000 Birr, but Ato Bogale sold it for a price of 30,000 Birr. In this case, even if W/ro Meselech acquired the right over the machinery before the date of declaration of bankruptcy of Ato Bogale, her right would not be respected. This is because she acquired the right as a result of undervalued transaction. While the market value of the machinery is 80,000 Birr, Ato Bogale sold it for a price of only 30,000 Birr, which is very much lower than the market price. As the transaction is undervalued, W/ro Meselech would not succeed in claiming the right over the machinery. The assumption here is that the debtor entered in such undervalued transaction with the view to affect the interest of the creditors. In other words, it is presumed that the debtor, knowing that he would be declared bankrupt and the properties are going to be attached, he deliberately entered in such undervalued transaction with the view of getting the property sold and converted into money. Note, however, here that the presumption is irrebutable one. In this relation you may also refer the provisions of Article 1995 and 1996 of the Civil Code, which read as follows:

*Art. 1995- Debtor's fraud*

A creditor may, in his own name, challenge the validity of acts whereby the debtor, in fraud of the creditor's rights alienated property or entered into obligations.

*Art. 1996- Fraudulent acts*

- (1) An act shall be deemed to have been done in fraud of the rights of creditors where it was done by the debtor so as to become insolvent, or with the knowledge that he was thereby increasing his insolvency.
- (2) The payment of mature debts may not be challenged by the creditors.

The second exception to the principle is that where the right is acquired as a result of improper preference to a creditor. Basically the principle under bankruptcy law is equality of creditors. As a result, it would not be proper if the debtor gives improper preference to one or more of the creditors. If that happens, even if the right is acquired before the date of the declaration of bankruptcy of the debtor, it shall not be respected. For example, assume that Ato Dawit could not pay his debts towards the debtors and as a result declared bankrupt on January 1, 2005. There were four creditors (Abera, Addisu, Gete, and Fanaye) who claim debt from Ato Dawit. Two weeks before the date of declaration of his bankruptcy, Ato Dawit concluded a contract of donation with one of his creditors, i.e., Gete. The debt of all the creditors is due and all of them were to demand payment from Ato Dawit. In this case, the creditor for was benefit the contract of donation is concluded (Gete) acquired the right as a result of improper preference. While he was nor doing was the same favor to the other creditors, Dawit improperly gave preference to that creditor. The assumption here is that had the thing given through donation not been given solely to one of the creditors, it would have been available for the benefit of all the creditors. But as a result of the preference, it is only the creditor to whose benefit the donation is made (i.e. Gete) that gets benefit of it. Therefore, the right of Gete would not be respected even if it was acquired before the date of declaration of bankruptcy of Ato Dawit.

**Principle II: Only the properties over which the debtor has interest are caught:**

There may be different properties under the possession of the debtor on the date of declaration of bankruptcy. Some of them may belong to the debtor himself and others belong to another person. The debtor might have received the properties belonging to

other persons either on hire, bailment or other reasons. As a result of declaration of bankruptcy, the properties of the debtor are to be attached and realized for the benefit of the creditors. Assets are available for distribution among creditors only to the extent that the debtor has or acquires a beneficial interest in them. Property in the possession of the debtor, but belonging to another is returnable to its owner, subject to any right which the debtor may have to keep in his possession (e.g. under a lease). This is not an asset available for distribution to creditors. Even if they are under possession of the debtor on the day of declaration of bankruptcy, the properties which belong to other persons should not be the subject of attachment and realization. In other words, it is only the properties over which the debtor has interest that have to be attached. For example, assume that W/ro Tsehay is a debtor who could not pay her debts towards her creditors and as a result declared bankrupt. On the date of declaration of bankruptcy, W/ro Tsehay possessed a refrigerator which belongs to Ato Zegeye. The refrigerator was possessed because of contract of pledge between Zegeye and Tsehay. In this case, the refrigerator shall not be considered as the property of W/ro Tsehay and be the subject of attachment. Rather it has to be given to Ato Zegeye, subject to the rights to which W/ro Tsehay is entitled against Zegeye.

What type of interest of the debtor do you think is to be considered? Did you answer “rights of ownership?” If your answer is so, that is correct. As we have seen earlier, the debtor may become possessor of properties belonging to other persons because of different reasons. He may become possessor because of pledge, mortgage, usufruct, bailment, etc. Where the possession is as a result of relationships other than those entitling to ownership, the rights of the real owner shall not be affected by the fact that the debtor is declared bankrupt. But where the debtor has acquired possession of the property as a result of a legal relationship that confers him the right of ownership, such property would be the subject of attachment and be realized for the benefit of the creditors.

To the rule that the trustee can take only assets belonging to the debtor at the date of commencement of the bankruptcy or acquired by the debtor thereafter, there are two principal statutory exceptions:

- A) The assets available to the general body of creditors may be swelled by the amount of payments or transfers made by the debtor before declaration of bankruptcy under a transaction which is void or voidable at the instance of the liquidation. Where the debtor has already made payments to persons entitled before the debt of declaration of his bankruptcy, that payment affects the assets available to the creditors. Where the debtor has already transferred certain properties belonging to him before the date of his declaration, still this affects the assets available for the general body of creditors. The trustee, representing the estate, takes what is available at the beginning of the bankruptcy proceedings. This is with the deduction of those payments or transfers made before the date of declaration of his bankruptcy.
  
- B) In a compulsory bankruptcy, all dispositions of the debtor's property made after the presentation of the bankruptcy petition are void unless authorized or ratified by the court. The fact that a petition to the bankruptcy of the debtor could not prevent the debtor from entering into different transactions. The debtor may dispose his properties though an application to his declaration of bankruptcy is already presented. Such disposition of the properties of the debtor would be valid only where there is court authorization. In the absence of court authorization or ratification of the disposal already made to the properties of the debtor, the transaction would be void. But where the court has ratified the disposition or has authorized for such disposition, the trustees take what remains after such disposition.

**Principle III: Personal Rights would be converted into rights of proof**

One of the important principles of bankruptcy law is that all the creditors shall stand at equal footing without any discrimination. In other words, all the creditors are expected to compete to get a certain portion from the proceeds of sale of the properties of the debtor.

In order to compete, all the creditors are expected to prove their respective rights before the responsible bodies. Even if the debtor admits that he is indebted to a certain creditor, after the declaration of his bankruptcy, there would be no way to get the right without passing through the process of proving his claim. For example, assume that Ato Kebede is a debtor who is declared bankrupt because he could not pay his debts towards his creditors. After the declaration of bankruptcy, one of the creditors approached the debtor and claimed payment of the whole or part of his claim from the debtor. In this case, the debtor cannot pay to the creditor because all his properties are administered by other persons.

In order for the creditor to get payment, he shall enter the procedure of proving his claim just like the other creditors. Had the debtor not been declared bankrupt, the creditor would have got payment without going into the procedure of proving debts. It would have been possible for the creditor to personally approach the debtor and satisfy his claim. On the part of the debtor, it is also possible to admit that he is indebted to the creditor and pay the whole or part of the debt he owes to the creditor. Generally, it is a cardinal principle of bankruptcy that purely personal rights against the debtor, whether to money, property or the performance of services, ceases to be exercisable by action and become converted into rights to prove in competition with other unsecured creditors. This characteristic marks off real rights from personal rights. The former are in principle unaffected by the bankruptcy process, for the trustee takes subject to them; by contrast, bankruptcy puts an end to a creditor's ability to enforce purely personal rights of an individual unsecured creditor to a share in realization of assets.

#### **IV. The unsecured creditors get *pari pasu* distribution**

It is an underlying principle that the unsecured creditors rank *pari pasu* and are thus entitled to a dividend proportionate to their respective claims. As you know unsecured creditors are those creditors who held nothing in security that guarantee performance of the obligations by the debtor. The antithesis of unsecured creditors is secured creditors. The refers to those creditors who took possession of a certain property or the title to

ownership of properties with the view of assuring performance of obligations by the debtor.

The overall objective of the bankruptcy proceeding is to collect the properties of the debtor and realize them for the satisfaction of the claim of creditors. In the process, those creditors who are secured would satisfy their claims from the property at their hand. As a result, it is the unsecured creditors who compete to get a certain share from the proceeds of sale of the properties of the debtor. In the process of distribution, each of the unsecured creditors could not get what he claimed. Rather the proceeds of sale, after certain expenses such as administration costs and the costs of carrying out the bankruptcy proceeding are deducted, would be distributed among the unsecured creditors based up on their claims.

What do you understand by *pari pasu* distribution? Did you answer saying, “it refers to proportionate distribution”? If your answer is so, that is great. It is distribution of the proceeds of sale of the properties of the debtor based upon the claim of each creditor. For instance, Ato Menbere is a debtor who is declared bankrupt for he failed to pay his debts towards the creditors. After all expenses are deducted, the proceeds from the sale of the properties of the debtor was 100,000 Birr. There were three creditors who proved their debts and claimed from Ato Menbere. One of the creditors, Ato Tesfu, claimed 30,000; the second creditor, W/ro Tizita, claimed 50,000 Birr; and the third creditor, Ato Geleta, claimed 100,000 Birr. In this case the claim of the creditors and the proceeds of sale of the properties of the debtor are not compatible. Therefore, what is available after sale has to be distributed proportionately among the three creditors in proportion to the claim of each creditor.

The principle of *pari pasu* distribution, which has been the feature of bankruptcy law, is often diminished because of certain reasons. First and foremost by the extensive range of security rights and analogous devices that have evolved over the years. As a result of development, creditors usually get a certain kind of security to guarantee the debtor’s discharge of his duties. The existence of such securities enables the creditors to satisfy

their claims from the securities in their hands. As a result, no competition would be with the other creditors for the proceeds of sale of properties of the debtor. Second, by the massive expansion of the range of debts made preferential by laws. Different laws recognize certain debts to be preferential and therefore the creditor would have preferential right against the debtor. In such cases, it is the other creditors, who are neither secured nor preferred, that compete for proportionate distribution of the proceeds of sale of properties of the debtor.

Do you agree that creditors who acquire a right after declaration of the debtor's bankruptcy are also entitled to *pari passu* distribution? Did you answer "No?" If so, you are correct. The principle of proportionate distribution applies only in relation to unsecured creditors who acquired a right before the declaration of bankruptcy. As we have discussed earlier, it is pre-liquidation rights that are to be respected. Those creditors who become creditors as the result of contract entered into by the trustee/liquidator are entitled to have their claims treated as expenses of the bankruptcy process and paid out of the assets in priority even to the claims of preferential creditors. For example, assume that Ato Tadesse is the debtor who is declared bankrupt on June 1, 2005. Before his declaration of bankruptcy there were four creditors to whom he is indebted. On declaration of his bankruptcy, W/ro Yodit was appointed as trustee to carry out the bankruptcy proceeding. With the view of carrying out the bankruptcy process, W/ro Yodit entered into a contract for the hire of a warehouse belonging to Ato Kebede. In the contract, it was agreed that Ato Kebede was entitled to the payment of 40,000 for the service he renders and the money would be paid after a month. In this case, even if he acquired the right after the declaration of bankruptcy of Tadesse, Kebede's claim would be paid in priority to the other creditors. The four unsecured creditors would get proportionate distribution of the proceeds from the sale of properties of the debtor. In other words, the proportionate distribution does not apply as regards the claims of Ato Kebede.

The rationale behind such a priority is that to enable the trustee/liquidator or the commissioners obtain goods or services during the bankruptcy process. Where there is no

such a distinct right the bankruptcy proceeding would not be carried out properly and speedily. No one would be willing to enter into transactions with a person or the representative of a person who is already declared bankrupt. But where one knows that he will be entitled to priority right in the distribution and not to compete for proportionate but full payment of his claims, then he would be encouraged to enter into transactions that can facilitate the bankruptcy process. In the above given example, had Kebede known that he would compete with the other unsecured creditors for *pari pasu* distribution, he would not have entered in such a transaction. As a result of the *pari pasu* distribution he would have got less than what he claimed (less than 40,000), while the priority right entitles him for the full amount he claims.

Do you accept that there could be instances where the pre-liquidation creditors can get priority right? If you answered “Yes”, that is correct. Even pre-liquidation creditors will be able to jump the queue where the trustee is dependent on their continuing to supply goods or services and they make it a condition that existing debts must first be paid. In such a case, the liquidator is entitled to pay the pre-liquidation claims in question as being expenses of the liquidation necessary to preserve the debtor’s business or its other assets. For example, assume that Ato Debalke is the debtor who is declared bankrupt for he could not pay his debts to the creditors. Before his declaration of bankruptcy, he concluded a contract for the supply of a raw material with W/ro Yemisrach. The latter used to supply the agreed quantity of raw material to the factory of Ato Debalke. After the declaration of bankruptcy of Ato Debalke, the court ordered for the continuity of the business for justifiable reasons. For the business to continue, it is necessary that the raw material continues to be supplied. As a result, the trustee is to continue the relationship with W/ro Yemisrach. In case Yemisrach demands prior payment of the debts due and not yet paid before the declaration of bankruptcy, the trustee can pay in priority to other unsecured creditors. It is necessary to facilitate the bankruptcy process and therefore, W/ro Yemisrach is entitled to get payment in priority.

### 1.4.2. Subsidiary Principles

The following subsidiary principles buttress the above mentioned cardinal principles.

- *Contracts entered into by the debtor before liquidation remain in force until disclaimed*

Before the adjudication of bankruptcy, the debtor is as free as any other person. As a result, he can enter into different contracts by which he may be creditor or debtor. Where he becomes creditor as a consequence of a contract entered before the date of declaration of his bankruptcy, the trustees can claim the right from the debtor of such contract during the bankruptcy proceedings. In other words, for the mere reason that the creditor is declared bankrupt the debtors of such contract could not refuse to discharge the obligations arising from the contract. Where he becomes debtor of the contract, the creditor of such contract can participate in the bankruptcy proceedings by proving his claims like any other creditor. Therefore, the principle is that the contract would not terminate as a consequence of declaration of bankruptcy of one of the parties. But where the contract is disclaimed, it shall not remain in force.

- *On liquidation, the debtor ceases to be the beneficial owner of its assets*

As you know, liquidation involves the realization of assets of a person into money. The process of liquidation is to be carried out not by the person found to be a debtor by another neutral person. In the case of bankruptcy, liquidation is to be carried out by the trustees. It is obvious that the trustees are not the owners of the properties belonging to the bankrupt person. In principle, it is the owner who can transfer valid title to another person. During liquidation, therefore, in principle the trustees could not transfer a valid title. Since one cannot transfer what he does not have, the debtor ceases to be the beneficial owner of the assets. In effect, by operation of the law, the ownership right is conferred on the trustees and as a result the debtor loses such right.

- *No unsecured creditor has any interest in specie in the debtor's assets or realization*

Basically, the right of unsecured creditors is a right in *personem*, and it is not a right in *rem*. In other words, the unsecured creditors have a right against the debtor, but not against the properties of the debtor. As their right is a right against the debtor and not against the assets, they cannot claim to take the properties of the debtor in distribution. Nor can they claim to participate in the realization of the properties of the debtor. What normally they are entitled to is to get distribution of the proceeds of sale of the properties of the debtor. To this effect, the properties of the debtor have to be identified and realized by a neutral body of persons, usually the commissioner and the trustees. Where the assets are not sufficient to cover the claims of creditors not secured, they are to get proportional distribution of the proceeds of sale. But as regards secured creditors, since they hold either movable or immovable properties belonging to the debtor, they have a right and interest in specie in those properties or the realization of such properties.

### **1.5. Bankruptcy Compared to Winding up**

Do you think that winding up is the same to bankruptcy? If you answered “Yes”, that is not correct. As we have seen earlier, bankruptcy is the judicial process by which the debtor is found not able to meet his commitments towards his creditor. On the other hand, the Black's Law Dictionary defines winding up as: “*process of settling the accounts and liquidating the assets of a partnership or corporation, for the purpose of making distribution of net assets to shareholders or partners and dissolving the concern.*” What one can infer from this definition is that winding up presupposes a company or another business organization where there are shareholders or partners.

#### **Points of similarity and difference**

- Winding up on the ground of insolvency may start by resolution of members of the company or the business organization. In this case, it is commonly known as members' voluntary winding up since it is their voluntary resolution that is the

cause for the winding up. Similarly, bankruptcy may be adjudicated based on the petition of the debtor himself. We will have a separate discussion on petition as one of the grounds for adjudication of bankruptcy later in this material. The fact that a company is in voluntary winding up does not debar a petition for it to be wound up by the court. Petition could be presented and the court orders the winding up of the company or corporation. There might be instances where the winding up process resulting from the resolution of the members stacks due to different reasons. In such cases, the court orders winding up and such order is to be effected.

- Winding up may also start by a winding up order on a petition by a creditor or other party having a *locus standi* to present a petition. In this case, it is known as compulsory winding up for it is not the members who wanted the winding up but the creditors or other persons having legal right against the company or the business organization. Regarding bankruptcy, one or more of the creditors can present petition to the effect that the debtor be declared bankrupt. Not only the creditors, but also the court and the public prosecutor can present petition for the declaration of bankruptcy of the debtor.
- Winding up does not divest the company of title to its assets but makes it in effect a statutory trustee of the assets for its creditors. As a consequence of the winding up process, the company would not totally lose the right of ownership over its assets. Normally, if the company or corporation loses the right of ownership, no one remains the owner until the property is sold. On sale, the buyer becomes the owner. But in the time between the beginning and end of the winding up process, the company or corporation remains the owner. Though it is the owner, there is no right to dispose or enjoy the fruits or even to make use of the properties. The company or corporation simply remains the trustee who keeps the asset properly. The same is true in the case of bankruptcy. The debtor remains the owner of his assets till the trustees transfer to other persons on sale.

- Control of the company passes to the liquidator (either the official receiver or an outsider or by the creditors). As a consequence of start of the winding up process, the company falls under control of the liquidator to be appointed to carry out the winding up process. In the case of bankruptcy also control of the assets and the business of the debtor falls into the hands of the commissioner and the trustees to be appointed for the purpose of carrying out the bankruptcy process.
- The liquidator is usually assisted by a liquidation committee and certain of his powers may be exercised only with the sanction of that committee or of the court. In the case of bankruptcy, however, the commissioner is to be assisted by the trustees and the creditors' committee. The court of jurisdiction is also to overlook and supervise the whole bankruptcy proceeding.
- The liquidator is responsible for getting in and realizing the assets, ascertaining the debts and distributing dividends. The trustees, in the case of bankruptcy, are responsible to collect and preserve the rights of the debtor, to realize the available assets and to distribute the proceeds among the entitled creditors.
- When all the assets have been got in, the liabilities established and the distribution completed, the winding up process is at an end. The final process is dissolution of the company, which terminates its legal existence. In the case of bankruptcy also, the process comes to an end on the final distribution of the proceeds of sale of the assets.

## **1.6. Conditions of Bankruptcy**

As we have discussed earlier, the Commercial Code did not define the concept of bankruptcy. It simply dealt with the conditions of bankruptcy. As per the Code, there are

two important conditions that need to be fulfilled for the existence of bankruptcy. The two conditions are suspension of payments and declaration of bankruptcy. In the absence of any of these two conditions there is no bankruptcy. In other words, the two conditions are cumulative rather than alternative. You can read the following provision as regards the conditions of bankruptcy:

*Art. 969- Conditions of bankruptcy*

Any trader who has suspended payments and has been declared bankrupt shall be deemed to be bankrupt.

What do you think amounts to suspension of payments? In other words, when can one say that there is suspension of payments? Reading of the provisions of Article 971 of the Commercial Code will enable you answer these questions.

*Art. 971- Facts constituting suspension of payments*

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

As you read in the above-given provisions the situation of suspension of payments arises from any fact, act, or document showing that the debtor is not able to meet his commitments. There are important issues to be raised in that relation. The *first* one is as to what facts can show that the debtor is no longer able to meet his commitments. Can you guess what facts could be considered? I hope that you have tried to list down certain facts that may show that the debtor is no longer able to meet his commitments. One fact could be that the debtor's business has continuously fallen from time to time for a long period of time. In other words, where the fact that the business has been falling down instead of growing up is clear, it can be inferred that the debtor has suspended payment.

The *second* issue is as to what act could indicate that the debtor is no longer able to meet his commitments. Can you guess possible acts that can show that the debtor is no longer

able to meet his commitments? If you do so that is great. Here, note that the act that can show that the debtor is no longer able to meet his commitments is the act of the debtor himself and not that of other persons. Accordingly, if the debtor has absconded without leaving or representing an agent to carry out the business, it could be a good example of an act to show that the debtor is no longer able to meet his commitments. Another example of an act could be where the debtor misappropriates or misuses his properties. Where it is corroborated with other circumstances, the unusual act of the debtor to misappropriate or misuse the properties could be a ground to infer the situation of suspension of payments. For example, assume that Ato Mesfin is the debtor of ten creditors. He has been performing commercial activities for the last seven years. During those times he has never misappropriated his assets and has properly managed them. But his conduct changed since the last two weeks in that he unusually misuses the assets. He drives the cars carelessly and even sells certain properties for a value much lesser than the market price. In this case, the act of Ato Mesfin can indicate that he is no longer able to meet his commercial commitments.

The *third* important issue is about documents. What documents are you going to consider saying that there is a situation of suspension of payments? You might have mentioned books of account, if any. If that is so, you are correct. In order to establish that the debtor is no longer able to meet his commitments, books of account, balance sheet and other similar documents can be good indicators. You can have a look at of the provisions of Article 973 of the Commercial Code, regarding the important documents to indicate suspension of payments.

*Art. 973- Documents to be annexed to the notice*

(1) The following documents, dated and signed, shall be annexed to the notice given under Art. 972:

- a) the balance sheet of the firm;
- b) the profit and loss of account;
- c) a list of commercial credits and debts, with the names and address of the creditors and debtors.

- (2) Reasons shall be given in the notice where any of the documents required under sub-art. (1) cannot be provided or is incomplete.

Even though the documents are expected to be presented along with a notice of suspension of payment by the debtor himself, the law considers such documents to assist the court to decide that a person should be declared bankrupt because he suspended payments.

Do you agree that the fact that one has suspended payments is sufficient for the bankruptcy of a person? Did you answer “No?” If your answer is so, you are right. Your answer is well supported by the provisions of Article 970 of the Commercial Code.

*Art. 970- Bankruptcy of fact*

- (1) Where no judgment in bankruptcy is given, bankruptcy shall not result from mere suspension of payments.
- (2) A sentence may be passed by a criminal court in respect of bankruptcy or any offence connected with bankruptcy notwithstanding that suspension of payments has not been established by a judgment in bankruptcy.

As you can read from the provisions of sub-article (1) of the above given Article, the mere fact that one has suspended payments could not suffice to his bankruptcy. Though the fact that he has suspended payments could be proved from different facts, acts, or documents, this by itself does not suffice bankruptcy. There should be judgment of bankruptcy of the same person along with the suspension of payments. In other words, the suspension of payments has to get court recognition as a result of which there has to be judgment of bankruptcy.

Another important point to be considered from the above mentioned Article is in relation to criminal matters. As we have seen earlier, for the existence of bankruptcy, the conditions of suspension of payments and declaration of bankruptcy are necessary. Even

though these conditions are not fulfilled, a court should not be prevented from deciding on criminal matters related to bankruptcy. In other words, the conditions of bankruptcy should not be a pre-condition for the court to entertain criminal cases related to bankruptcy. Where suspension of payments is proved, even though it is not established by court declaration, a criminal court can pass judgment on matters of crime related to bankruptcy.

## **Chapter Summary**

In this Unit we have discussed a number of important points. One of such points is the historical background of bankruptcy. Its origin goes back to the older times of the 14<sup>th</sup> Century. The origin is mainly related to the Italian merchants of the Renaissance period. It later spread to the central European and other countries. When it comes to Ethiopia, the concept was borrowed from the experience of other foreign countries, especially from that of the French experience.

The other important point we have discussed is the definition of the word bankruptcy. There is no universally accepted definition of the word. Different scholars defined the word differently because of difference in their perspectives. In spite of this difference, we have taken definitions for our purpose. We have also seen as to how the Commercial Code defined the word. Accordingly, it has come up with two different definitions which take into account different considerations. Net to its definition, we have discussed the scope of bankruptcy under the Commercial Code. Accordingly, bankruptcy by its nature is related to persons involved in business activities. As a result a person who is not a trader within the meaning of the law could not be the subject of bankruptcy. If a business organization is a trader within the meaning of the Commercial Code, it could be the subject of bankruptcy where the requirements are complied with.

In this unit we have also focused on the cardinal principles of bankruptcy. There are principles that serve the function of a constitution as far as bankruptcy proceeding is concerned. Such principles are general and comprehensive, which have subsidiary

principles. All the provisions of the bankruptcy law are in line with these principles and are supplementing them. We have also discussed the comparison and contrast between the concepts of bankruptcy and winding up. There are points of similarity as well as difference between these two concepts. Last, but not least, we have discussed the conditions of bankruptcy. In order to consider that there is a situation of bankruptcy, there should be two conditions. One is the existence of suspension of payments and the other the declaration of bankruptcy. These two conditions are cumulative in that one only could not suffice to consider that there is bankruptcy.

## **REVIEW QUESTION**

1. Does the commercial code of Ethiopia recognize the three tests of Bankruptcy? What are the tests, if any, recognized by the Ethiopian Commercial Code? Based on the way the relevant provisions of the commercial code are formulated, do you think it is discernable when to use which test? What is it that may be gatherable from the provisions of Article 971 for the purposes of determination of the tests mentioned above? What is your opinion about Article 973?
2. The USAID Diagnostic Report says that there have only been less than a dozen court cases of bankruptcy in Ethiopia. Why is it that bankruptcy provisions of the commercial code are, literally, not put into application in Ethiopia?
3. Define the word Bankruptcy in light of the commercial code of Ethiopia.
4. Why do you think joint venture is excluded from the scope of application of bankruptcy?
5. Explain the Basic Cardinal Principles from which all the subsidiary rules and principles of bankruptcy emanate.
6. Discuss the instances in which the bankrupt debtor can be possessor of properties belonging to other persons?
7. Point out the similarity and differences between Bankruptcy and winding up.
8. Explain the two important condition of Bankruptcy.

## **CHAPTER TWO**

### **JUDGEMENT OF BANKRUPTCY AND ITS EFFECTS**

#### **Introduction**

The conditions for bankruptcy may exist due to different reasons. We have discussed those conditions as per the Ethiopian Law of Bankruptcy. Accordingly, in order to say that there is bankruptcy, there should be suspension of payments and declaration of bankruptcy. After proof of the existence of conditions of bankruptcy, the next question is as to what follows. In this chapter we will try to find the answer for this and other related questions.

The chapter is divided into two sections. The first section is on the judgment of bankruptcy. In this section we will discuss the different grounds for the judgment of bankruptcy. The second section is on the effect and enforcement of the judgment of bankruptcy. In this section, we will be focusing on the effects of the judgment in bankruptcy as regards the debtor as well as the creditors. We will also discuss as to how the judgment is to be enforced after the court adjudged the debtor bankrupt.

#### **Objectives**

At the end of this chapter, you should be able to:

- enumerate the grounds for the judgment of bankruptcy;
- discuss each of the grounds of judgment in bankruptcy;
- identify the person entitled to apply for setting aside the judgment;
- distinguish that the judgment is to be enforced temporarily;
- identify the reason why the judgment is to be enforced temporarily;
- discuss the grounds for setting aside the judgment;
- identify the persons entitled to appeal against the judgment of bankruptcy, and
- dispose practical cases in relation to the judgment in bankruptcy.

## 2.1. The Judgment of Bankruptcy

In the process of the bankruptcy proceeding, the first and the most important step is the judgment of bankruptcy. Judgment of bankruptcy is said to be the most important step because it is the stage at which the fate of the debtor is to be decided. Where the court decides that the debtor should not be adjudged bankrupt, the whole process ends there. But it is only where judgment in bankruptcy is passed that the next step in the process continues. The judgment in bankruptcy establishes that there is suspension of payment and as a result declaration of bankruptcy. The important issue to be raised at this juncture is which court can pass the judgment in bankruptcy. In order to enable you attempt to answer the question, you are requested to read Article 974 of the Commercial Code:

### *Art. 974- Court having jurisdiction*

- (1) The Ethiopian court having jurisdiction in bankruptcy proceedings shall be the court of the place where the business of a trader who is a person is situate or, where there is more than one business, the place where the principal business is situate.
- (2) Subject to the provisions of international conventions, the Ethiopian court shall have jurisdiction notwithstanding that the principal place of business is abroad and a foreign court has exercised bankruptcy jurisdiction.

As per the afore-mentioned Article, bankruptcy matters are within the jurisdiction of the court of the place where the business situates. It is not expressly stated that it is the Wereda/ First Instance Court or the High Court of the place where the business is situated. Where there is no such precision, a dispute may arise between the parties as regard to the court having jurisdiction. For example, where the creditor has instituted petition before the High Court of the place where the business is situated because it is the nearest court, the debtor may present objection. He may claim that it is the Wereda Court of the place where the business is situated that has proper jurisdiction. This he may say because the Wereda Court is the nearest to his place of business or residence.

For appropriate determination of jurisdiction, the rules of the civil procedure on jurisdiction shall be considered. The provisions of Article 15(2) (b) of the Civil Procedure Code provide that bankruptcy matters fall within the exclusive jurisdiction of the High Court. In other words, irrespective of the material jurisdiction, the High Court shall have jurisdiction on bankruptcy matters in their first appearance. Based on this idea, can we then say that the court having jurisdiction on bankruptcy matters is the High Court? As far as the practice among the Ethiopian courts is concerned, bankruptcy cases are to be instituted before the High Court.

The provisions of Article 11 of the Federal Courts Proclamation (Proclamation No. 25/96) do not expressly indicate that bankruptcy falls within the jurisdiction of the Federal High Court. While civil matters that fall within the jurisdiction of the Federal High Court are enumerated, the enumeration does not include bankruptcy. In the same Proclamation, there is a provision which provides that all matters not expressly included within the jurisdiction of the High Court shall fall within the jurisdiction of the First Instance Court. This implies that bankruptcy falls within the jurisdiction of the Federal First Instance Court.

After identifying the court having jurisdiction on bankruptcy matters, the next question is as to how the court comes to the stage of judgment of bankruptcy. Now let us discuss the procedure of judgment of bankruptcy. There are three important grounds for the judgment of bankruptcy, namely:

- petition of concerned party;
- retirement; and
- death of a person.

Now, let us discuss each of these grounds

**a) Judgment on petition by concerned party:**

After the court having jurisdiction is identified, the bankruptcy proceeding is to be instituted by way of petition. One or more of the entitled persons can institute a petition before the court. Who do you think is entitled to institute petition before the court? You might have enumerated some category of persons entitled to petition. If you did so, that is great. Now read the provisions of Article 975 of the Commercial Code.

*Art. 975- Proceedings how instituted*

Bankruptcy proceedings shall be instituted by way of petition made by:

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

As you read from the above- provision, there are four categories of persons entitled to institute petition before the court. The *first* category is the debtor himself. According to the provision, the debtor can institute petition for declaration of his own bankruptcy. Apparently, it seems unbelievable that the debtor himself demands declaration of his own bankruptcy while bankruptcy has a number of disadvantages as regards the debtor. For instance, as a result of declaration of bankruptcy, the debtor would get ridiculed. The credibility of the debtor would decline where he is declared bankrupt. The debtor would lose the right to administer and manage his properties as a result of declaration of bankruptcy. Moreover, the value of his properties would decrease or there would be depreciation in case where the bankruptcy process is prolonged due to certain procedures. An important issue to be raised, therefore, is why the debtor takes initiative to institute petition for his own bankruptcy while bankruptcy has such disadvantages.

Do you accept that bankruptcy has advantages to the debtor? Did you answer “Yes?” If you answered so, that is correct. Though bankruptcy has the above mentioned disadvantages to the debtor, sometimes it could be found advantageous to the debtor. As

far as the rules of bankruptcy are concerned, there is the so called principle of discharge. It provides that the debtor would no more be liable to the creditors after all his properties are collected and realized for the benefit of the creditors. After winding up and closure of the bankruptcy proceeding, the debtor can start his business in a new slate. Even if he gets much money, the creditors lose the right to claim the unpaid amount of their previous claim. In such cases, the debtor gets advantage by losing properties in his hand and being discharged from liability then after. Therefore, in view of such advantages the debtor can take initiative to institute petition before the court for declaration of his own bankruptcy.

The *second* category of persons entitled to institute petition is one or more of the creditors. It could not be an issue as to why the creditors can institute petition for the declaration of bankruptcy of the debtor. Rather what could be raised as an issue is the extent of claim the creditor/s needs to have in order to institute the petition. Sometimes the creditor can have a claim of only a small amount of money. For example, assume that Ato Mindaye is the debtor who failed to pay to his creditors. There are fifteen creditors claiming money from Ato Mindaye. Of the fifteen creditors, one (W/ro Tihun) has only a claim of five Birr. The total claim of all the creditors is three million Birr. Should W/ro Tihun allowed to institute petition for the declaration of bankruptcy of Ato Mindaye? Did you answer “Yes?” If your answer is so, that is correct as far as the Commercial Code is concerned. There is no limitation as regards the amount of claim a creditor should have in order to institute petition. Therefore, legally, it could be said that to the extreme a person who has a claim of even cents can institute petition for the declaration of bankruptcy of the debtor.

However, the experience of other countries, especially of Britain, shows that in order to institute petition for the declaration of bankruptcy of the debtor, the claim of a single creditor or several creditors should be not less than 180 Sterling Pounds. When we come to our Commercial Code, if it is allowed that a person who has a claim of very small amount is allowed to institute petition, we can simply guess the social impact of such practice. Therefore, one can argue that it is better if a certain ceiling is provided by the

law so that it would be allowed only where the claim of the creditors is equal to or more than that ceiling.

The *third* category of persons entitled to institute petition is the public prosecutor. Normally the public prosecution office is to be established to protect the public interest regarding criminal matters. In few cases, the public prosecutor may interfere in civil matters as provided by the law. Accordingly, as provided by the Civil Code, the public prosecutor can involve in civil matters concerning the minors and matters related to marriage.

The question as regards bankruptcy is why the public prosecutor should intervene in matters of bankruptcy and allowed to institute petition for the declaration of bankruptcy of the debtor. Do you think that bankruptcy proceeding is the criminal matter? I hope your answer will be “No”. If so, you are right. If the proceeding is not criminal, then is there an element of crime in the bankruptcy proceeding? Sometimes, the bankruptcy of a person could be related to crime. For instance, there could be a situation of fraudulent bankruptcy. In such cases, it could be appropriate if the public prosecutor institutes petition for the declaration and investigate the criminal act. Otherwise, one could not clearly see why the public prosecutor is entitled to institute petition for the declaration of bankruptcy of the debtor. Even if it is by representing either the debtor or the creditor/s, the law maker has not expressly indicated to that effect. For that matter there is no considerable public interest to be represented by the public prosecutor. Therefore, one possible case in which instituting petition by the public prosecutor would be justifiable is where the creditor/s and the debtor are ignorant and the interest of the public could be more protected if the debtor is declared bankrupt than otherwise. One could, however, guess the justification of intervention by the prosecution in relation to the duty of the government a protector of rights of individuals.

The *fourth* category entitled to institute petition is the court itself. The court, like that of the public prosecution office, is normally established to protect the interest of the public at large in matters of justice. Unlike the public prosecutor, it is not only in relation to

criminal matters that the court protects interests of the public, but also in civil matters. Being one of the organs of the state, the court is a sub delegate of the public at large. There might be instances where the court comes to identify a debtor who has informally suspended payment. The court can identify such debtors in the course of discharging its normal and ordinary judicial functions. In such cases, where it believes that the interest of the public would be more protected if the debtor is declared bankrupt than otherwise, the court can institute petition for the declaration of bankruptcy of the debtor.

An important issue to be raised in relation to the entitlement of the court to institute petition is that which court should be entitled. If it is the court which has jurisdiction on bankruptcy matters, then it will be the same court that presents the petition and decides on the petition. Do you think that it would be fair if the same court institutes petition for the declaration of bankruptcy of the debtor and decides on the presented petition? I am sure that your answer will be “No”. If so, that is correct. The court, in this case, becomes a judge of its own case. One of the requirements of fair justice and adversarial trial is judgment by a neutral body than the parties to the case. Where it institutes a petition for the declaration of bankruptcy of the debtor, the court automatically becomes one of the parties to the case. One of the characteristics of a code is the uniform use of a word across all the provisions, unless otherwise meaning is given to the word expressly. The word ‘court’, as used under Article 974 of the Commercial Code, refers to ‘the *court that has jurisdiction on bankruptcy matters.*’ As said above, the same meaning is to be attached to the word under Article 975(d) of the Commercial Code. There could be no way for another court than the one having jurisdiction, to institute petition. The expression used under Article 975(d) indicates that the court is not another one because it says “the court itself”. It could also be argued that had the legislature intended another court to be the one to institute petition, it could have expressly indicated or qualified it.

After the petition is instituted by one or more of the persons entitled to do so, the next step is to be decided by the court. On receipt of the petition, the court has two options, namely: making preliminary investigation and going to first hearing. Where it is found appropriate in the eyes of the court, it can enter into making preliminary investigation

about the affairs of the debtor. The mere fact that the person entitled has instituted petition could not directly enable the court to adjudge the debtor bankrupt. Sometimes the debtor may want to get declaration of bankruptcy fraudulently. In other cases the creditor may simply institute petition for the declaration of bankruptcy of the debtor without the latter really suspended payments. Where the debtor is declared bankrupt without the affairs of the debtor being properly investigated it will have a negative impact on the interest of the public. Therefore, where the court thinks appropriate, it can order investigation of the affairs and activities of the debtor.

The court can appoint one of the judges within the court to carry out the investigation of the affairs of the debtor. The task of investigating into the affairs and activities of the debtor may not be accomplished by the effort of the judge appointed. In case where there is a need for assistance of another person, the judge can get the assistance of a trustee. As to who the trustee is we will see in the future. Just for your information, the trustee is a person to be appointed to administer the assets of the debtor after declaration of bankruptcy. After involving in the task of investigating the affairs and activities of the debtor, the appointed judge is expected to report to the court all information he gets in the course of such investigation. Read Article 976 of the Commercial Code:

*Art. 976- Preliminary investigation*

- (1) The court may, where it thinks fit, appoint a judge for the purpose of investigating into the affairs and activities of the debtor.
- (2) Any judge so appointed may require the assistance of a trustee.
- (3) All information collected shall be reported to the court.

An important issue that could possibly be raised in relation to the appointment of a judge to investigate into the affairs and activities of the debtor is in case of one judge in some courts. If we accept that the court as having jurisdiction is the First Instance/Wereda Court of the place where the business is situated, in most of the Wereda Courts of our country, there is only one judge in charge of the judicial function. Where there is such a factual situation, how can it be possible to appoint the same judge to investigate the

affairs and activities of the debtor and to get a report of the investigation? Moreover, the same judge is going to decide on the fate of the debtor based on the report of investigation. One can therefore see that there will be problem of implementation of investigation by judge where there is only a single judge in the Wereda court. For that matter there is no law that has determined the number of judges in Wereda courts to be only one. It is due to the long lasted scarcity of persons qualified in the area of law that the practice developed. Otherwise, the presumption is that there are at least three judges in each bench to dispose a case in all levels of courts.

If the court finds that making of investigation is not appropriate, it can enter into first hearing. During such hearing the one who presented the petition is to prove the fact that the debtor has suspended payments. In other words, the first hearing is the stage at which the court hears the parties to decide whether the debtor has suspended payments, without involving itself in carrying out investigation of the affairs and activities of the debtor.

What do you think is the effect of the two options, i.e., the preliminary investigation or the first hearing? Whether the court has opted for preliminary investigation or first hearing, it is for the purpose of determining the date of suspension of payments and declaring the debtor bankrupt.

Now read the provisions of Article 977 of the Commercial Code:

*Art- 977- Determination of the date of suspension of payments*

- (1) At the first hearing or, where appropriate, on receiving the report under Art. 976, the court shall:
  - (a) fix the date of suspension of payments; and
  - (b) subject to the provisions relating to schemes of arrangement, declare the debtor bankrupt.
- (2) Where the date of suspension of payments is not fixed, such date, subject to the provisions of Art. 978, shall be deemed to be that of the judgment declaring the debtor bankrupt.

The date of suspension of payments could not be clearly traced. This can happen where there is no sufficient evidence to show the exact date on which the debtor has suspended payments. Where the court has faced difficulty in identifying the date of suspension of payments, the date on which the debtor is declared bankrupt shall be deemed the date of suspension of payments. For instance, assume that Ato Bekele is the debtor who failed to pay debts and as a result suspended payments. His business has started to decline a year ago but it is not known as to when he exactly suspended payments. The court declared Bekele's bankruptcy on July 10, 2005. In this case, the date on which Bekele was declared bankrupt shall be taken as the date of suspension of payments. Therefore, it is July 10, 2005 when Bekele is deemed to have suspended payments and therefore all the rights and obligations of the parties would start to run from that date.

Do you agree that the date of suspension could be extended from what is fixed by the court? Did you answer "Yes?" If your answer is so, it is correct. The provisions of Article 978 of the Commercial Code support your answer. As per the provisions of the Article, the date of suspension of payments fixed to be the date of declaration of bankruptcy may be made the subject of extension. As we have seen earlier, such date is fixed because the exact date of suspension of payments could not be traced because of certain reasons. It is not the real date of suspension of payments and therefore subject to change in case there is proof otherwise. After the judgment in bankruptcy had been passed, there could be instances where the date of suspension fixed earlier could be extended. Such a date can be extended where the trustee or any interested person applies to that effect by presenting sufficient evidence to prove that the exact date of suspension of payments is different from the date of declaration of payments. Moreover, the public prosecutor or the court can also apply for the extension of the date of suspension of payments with the view of protecting public interest. It has to be noted, however, that each of them should have sufficient evidence to prove that the exact date of suspension of payments is different from the indicated date of declaration of bankruptcy of the debtor.

Do you think that the date of suspension of payments fixed by the court, based on the proof to that effect can be extended, if the court found evidences? If you answered “Yes” that is great. Such a date can be extended in limited circumstances. It can be extended only within eight days from the time of notice being published in the Commercial Gazette. After the expiry of such period, no application for the extension of the date of suspension of payments could be entertained by the court- (read Article 978(2) of the Commercial Code). In all cases, however, the date of suspension of payments could not be extended for a period more than two years before the date of declaration of bankruptcy. In other words, a date of suspension of payments, later than two years back from the date of declaration of bankruptcy, would not be acceptable and relied as proper date of suspension even if it is fixed by the court (Article 978(3)).

#### **b) Judgment on Retirement**

The name of a trader may be cancelled from the registry for various reasons. As per the provisions of Article 112 -114 of the Commercial Code, the name can be cancelled because of different causes. Read the following provisions

##### *Art. 112- Cessation of trade*

Any registered person shall apply for the registration to be cancelled within two months from his ceasing to carry on his trade or where he lets his business out for hire.

##### *Art. 113- Death of trader*

- (1) The heirs of a deceased trader shall apply for the registration to be cancelled within two months from the death.
- (2) Where the heirs carry on the trade under joint ownership, they shall apply for a new registration to be entered.
- (3) Where the joint ownership is dissolved, the entry made under sub-art (2) shall be cancelled and the person to whom the business is assigned shall apply for a new registration to be entered.

As you read from the given provisions, the trader may be cancelled from the registry because of cessation of trade, or death of the registered trader. There might be several reasons why the trader ceases trade. For instance, it could be because of changing the business or decline in capital. It also could be because of decline in demand or the leave of the trader the area of his business. Whatever the cause for the cessation of the trade may be a person should apply for the cancellation of the registration. The application has to be made within a period of two months from the time the trade ceased to exist.

In case if a person who has been registered as trader dies his heirs should apply for the cancellation of such person from the registry. In this case, the application has to be made within two months period from the time of death of the trader. It is logical that the name of the trader should be cancelled from the registry where he died.

You remember that the scope of bankruptcy applies to both traders, within the meaning of Article 5 of the Commercial Code, and commercial business organizations, within the meaning of Article 10 of the Commercial Code. As regards business organizations that carry out trade, cancellation is regulated by the provisions of Article 226 of the Commercial Code, which reads as follows:

*Art. 226- Cancellation of registration*

Where a business organization is dissolved and wound up, the liquidators shall apply for the registration of the business organization in the commercial register to be cancelled. The business organization shall have no legal personality after cancellation has been published in the Official Commercial Gazette.

According to the above provision, a business organization may be cancelled where there is a situation of dissolution and winding-up of the organization. Where a business organization is dissolved and wound up its existence comes to an end. In such cases, it is logical that the liquidator applies for the cancellation of registration of the organization

because a person whose life has come to an end should not remain registered as if it were existing. But you have to note that the personality of the organization does not come to an end automatically. Its existence comes to an end only from the time of publication of the cancellation in the Official Commercial Gazette.

The recently promulgated proclamation of the Federal Government on Commercial Registration and Business Licensing (Proclamation No 67/1997) regulates cancellation under Article 10. It provides that without prejudice to the provisions of Articles 112, 113 and 226 of the Commercial Code, the appropriate authority shall decide to cancel the registration upon his being aware of the fact that either the business person has ceased to operate his business or there is a lawful decision prohibiting him to carry on his business. In other words, it provides that the appropriate authority should decide the cancellation in a way not contradictory with the relevant provisions of the Commercial Code regulating cancellation of registration.

Do you agree that a person whose registration is cancelled can be declared bankrupt? If you answer “Yes” you are right. As per the provisions of Article 979 of the Commercial Code, a person, either a trader or a commercial business organization, whose name is struck off the commercial register may be declared bankrupt. However, you have to note that it is not all persons whose registration is cancelled that can be declared bankrupt. It is only persons who suspended payments before the cancellation of registration. After he/it has suspended payments and his/its name is struck off from the commercial register, the person may be declared bankrupt within a period of one year. But where the person is not registered in the commercial register, while he is a trader or commercial business organization, the bankruptcy of such person can be declared any time. But you have to note that there should be suspension of payments on the part of the person to be declared bankrupt. As we have discussed earlier, one of the conditions for the bankruptcy of a person is suspension of payments. Where there is suspension of payments and the person is not registered, while he should have been registered, the court can declare bankrupt such person any time. In other words, there is no time limit within which the person is to be declared bankrupt.

### **c) Judgment after Death**

Do you agree that death of a trader has always the effect of declaring bankruptcy? Did you answer “No?” If your answer is so, you are correct. The mere fact that a trader dies should not have the effect of his being declared bankrupt. Apart from the death, there should be suspension of payments. One can question here as to when the suspension of payments is to be considered. The deceased person might have suspended payments before his death or it could take place after his death. Normally, the fact that suspension of payments takes place after the death of the person could not logically cause declaration of bankruptcy of the deceased person. Therefore, it is suspension of payments before the death of the person that has to be considered and become a ground for the declaration of bankruptcy of the same person.

Another issue to be raised in relation to declaration of bankruptcy after death is the period within which the declaration is to be made. Alike the case of judgment on retirement, the declaration of bankruptcy of the deceased person should be within one year from the time of death of the person. You can read Article 980 of the Commercial Code:

#### *Art. 980- Bankruptcy after death*

- (1) Where a trader who is a person dies after having suspended payments, he may be declared bankrupt within one year after his death.
- (2) The petition may be lodged by:
  - (a) a creditor; or
  - (b) the public prosecutor; or the court itself.
- (3) An heir may lodge a petition for bankruptcy in order to prevent the assets of the succession being mixed with his own property.
- (4) Adjudication of bankruptcy after death shall suspend the effect of the separation of estates obtained by the creditors of the deceased under the provisions of the Civil Code.

The above mentioned Article reveals that a person who is dead could also be declared bankrupt. Don't you think that this is something amazing? One may question that if a person who is dead is declared bankrupt while he is in his grave, how logical could the declaration be. Normally, the declaration of bankruptcy is due to the suspension of payments before his death. The paradox would be in case where he passed away without leaving any property behind or left very few. But where he died leaving properties, it is acceptable to declare him bankrupt and the creditors get distribution of proceeds of sale of the available properties.

## **2.2. Effects of Judgment**

As a result of the adjudication in bankruptcy of the debtor, certain effects follow. The effects could be either as regards the debtor or the creditors as a result of adjudication of bankruptcy of the debtor. Had there been no judgment in bankruptcy of the debtor, the effects would not have occurred. In this unit we are going to discuss the different effects to result from the declaration of bankruptcy of the debtor.

### **2.2.1. Effects as regards the Debtor**

The adjudication of bankruptcy of the debtor brings about several effects. The major effects could be categorized into: prohibitions or restrictions; rights or privileges; and invalid acts. Now let us discuss each of these categories of effects in the following paragraphs.

#### **A) Prohibitions or Restrictions**

Certain prohibitions or restriction could be imposed on the rights and freedoms of the debtor as a result of the adjudication of bankruptcy. The prohibitions or restrictions are in relation to: the freedom of movement, the legal prohibitions or forfeitures, the management of properties, and the freedom of communication.

Article 32 of the FDRE (Federal Democratic Republic of Ethiopia) regulates the freedom of movement of individuals as follows:

1. Any Ethiopian or foreign national lawfully in Ethiopia has, within the national territory, the right to liberty of movement and freedom to choose his residence, as well as the freedom to leave the country at any time he wishes to.
2. Any Ethiopian national has the right to return to his country.

From the above provision we can understand that any person, whether he is a citizen of Ethiopia or otherwise, is entitled to move from place to place without any restriction. The foreigner has to enter Ethiopia lawfully. The freedom to move applies within the boundaries of the country. Not only to move within the country, but also the freedom to leave the country at any time. However, you have to note here that this is constitutional provision that is comprehensive and general. As a result, it does not mean that the freedom of movement is an absolute one.

Do you think that the debtor is as free as any person to move from place to place? You might have answered “Yes”. If your answer is so, you are not correct. After the adjudication of his bankruptcy, the debtor is not as free as he was before such declaration. He is also not as free as any other person who is not declared bankrupt. The debtor is not free to leave his place of residence. If he wants to leave such place, the debtor has to secure permission of the commissioner. You see, his freedom to move from place to place is restricted. Note here that he is not totally deprived of the freedom to move from place to place. It is a relative restriction. Where he got permission of the commissioner, he can move leaving his residential place. What will be the effect if the debtor moves from his place of residence without getting permission of the commissioner? As per the law, the debtor is to be exposed to criminal charge under the provisions of Article 433 of the Penal Code. This Article of the Penal Code regulates resistant behavior to authority. Therefore, where the debtor leaves his residential area without permission of the commissioner, it is to be considered as resistance to authority (Read Article 1019 of the Commercial Code).

What do you think is the rationale behind restriction of the freedom of movement of the debtor? The bankruptcy proceeding could be facilitated if the debtor is around his residential area. If he is left free to move from his place of residence, at times where his presence is found to be important, he would be not present and that may retard the pace of the proceeding. Moreover, where the debtor is free to move from place to place, probably he may abscond and the proceeding may be interrupted.

Different prohibitions or forfeitures may result from the operation of the law as a result of adjudication of bankruptcy. For instance, different laws regulate that a person who is declared bankrupt is not fit to be security, guarantor, an agent, liquidator, etc. Even under the part of the Commercial Code regulating bankruptcy, a person who is declared is not fit to be appointed as trustee or commissioner in the bankruptcy of another person. Read Article 1022 of the Commercial Code.

*Art. 1022- Prohibitions and forfeitures*

The bankrupt may be subjected to such prohibitions or forfeitures as are provided by law. Unless otherwise provided by law, such prohibitions or forfeitures shall cease to be effective where the convicted bankrupt is reinstated.

As a result of the adjudication of his bankruptcy, the debtor would be exposed to the prohibitions or forfeitures to result from law. As mentioned earlier, the debtor would not be fit to be appointed as tutor of a minor or liquidator in the winding up process of a business organization. It would not be proper to appoint a person who is declared bankrupt to be a trustee or commissioner. Moreover, if you read the provisions of Article 680-689, and 122-125, of the Penal Code, you will find instances where the debtor could forfeit rights due to the fact that he is declared bankrupt. The provisions of Article 242-247 of the same Code are about possibilities of reinstatement of the debtor.

How do you think that the debtor could be reinstated? As we have discussed earlier, the debtor could be reinstated where the judgment in bankruptcy is set aside or the appellate court reversed the judgment of the lower court. Where there is sufficient evidence presented by the person who applied to the set aside of the judgment of the court, the adjudication of bankruptcy could be set aside. Where the adjudication is set aside, the debtor regains his rights to be lost as a result of the declaration. Therefore, the prohibitions or forfeitures shall cease to continue and the debtor is to be allowed to full right as he had before the time of adjudication of bankruptcy.

The FDRE Constitution, under Article 40 provides for the right of individuals to property. As per this Article, every citizen of the country has the right to the ownership of private property. The right to private property shall include the right to acquire, to use and, in a manner compatible with the rights of other citizens to dispose of such property by sale or bequest or to transfer it otherwise. However, this right to private property is not an absolute one. It is relative in that the right may be restricted where there is a law to that effect.

Do you agree that the debtor loses the right to administer his properties as a result of his adjudication of bankruptcy? In order to answer the question, now read the provisions of Article 1023 of the Commercial Code.

*Art. 1023- Bankrupt unable to deal with his property*

A bankrupt shall not administer or dispose of his property, however acquired, from the day he is declared bankrupt until he is discharged.

As the above-mentioned Article provides, the debtor is totally deprived of the right to deal with his property. Though his right is constitutionally guaranteed, the declaration of bankruptcy automatically snatches the right from the debtor. As a result, the debtor could not deal with his property. The properties of the debtor are to be administered by the trustee after they are handed over to him at the end of inventory. Not only the right of administration, but also the right to dispose the properties is to be denied.

Which property of the debtor is not to be administered or disposed by the debtor as a result of declaration of bankruptcy? In other words, does the debtor lose the right of administration or disposal of properties not related to his commercial activity? As we discussed earlier, the scope of bankruptcy is limited to matters related to the commercial activities and commitments of the debtor. Normally one can, therefore, raise the issue under discussion. As per the provisions of Article 1023 of the Commercial Code all properties belonging to the debtor are not to be administered or disposed by the debtor. Whether acquired through succession or in the course of carrying out the business, all the properties are under the restriction. However, note that the fact that the properties are not to be administered by the debtor does not guarantee that all of them are to be sold for the benefit of the creditors.

The constitutional guarantee as regards the privacy of individuals is provided under Article 26 of the FDRE Constitution. For better understanding, you are requested to read the provision of the Constitution.

*Article 26 Right to privacy*

1. Everyone has the right to privacy. The right shall include the right not to be subjected to searches of his home, person or property, or the seizure of any property under his personal possession.
2. Everyone has the right to the inviolability of his notes and correspondence including postal letters, and communications made by means of telephone, telecommunications and electronic devices.
3. Public officials shall respect and protect these rights. No restrictions may be placed on the enjoyment of such rights except in compelling circumstances and in accordance with specific laws whose purposes shall be the safeguarding of national security or public peace, the prevention of crimes or the protection of health, public morality or the rights and freedoms of others.

Do you agree that the debtor has the freedom of communication? Did you answer “Yes”? If so, you missed it. As in the case of freedom of movement, the debtor is not as free as he was before the day of declaration of his bankruptcy to communicate by letter. As you read in the above constitutional provision, the right to privacy could be restricted if there is specific law and in compelling circumstances. Accordingly, there is restriction to be imposed on his freedom as a result of the declaration of bankruptcy. All the letter communications are to be made through the trustee and the debtor has the right to be present where letters addressed to him are opened by the trustee. Here note, however, that it is only incoming letters that are under scrutiny of the trustee but not out going letters. The provisions of Article 1012 of the Commercial Code provide that the debtor has the right to be present when letters addressed to him are opened by the trustees.

## **B) Rights or Privileges**

As a result of the declaration of his bankruptcy, the debtor is to be entitled to different rights or privileges. Such rights or privileges would not have existed if there had been no declaration of bankruptcy of the debtor. The major rights or privileges to result from the declaration of bankruptcy of the debtor are: the right to get means of subsistence; the privilege of employment; the right to outstanding debts; and the right to be relieved from paying interest on debts. Now let us discuss each of these rights or privileges in the following paragraphs.

After declaration of bankruptcy, we have discussed that the debtor loses his right to administer or dispose his property. As a result, he could not deal with his property as he wishes, though such is a right of an owner. Because he lost administration of his properties, the debtor is entitled to assistance for his own and the life of his family. The trustee can request the commissioner to apply part of the properties of the debtor for the life of the debtor and his family. This is the first privilege or right of the debtor even under the declaration of bankruptcy. The properties to be applied for the assistance of the debtor and his family are to be used only where there is permission of the commissioner to that effect.

What do you think is the rationale behind such right of assistance? You might have tried to enumerate reasons you think are appropriate. If so, that is great. The major reason why the debtor and his family should be given the right to assistance is because they would be burden to the society. If the debtor himself and members of his family are deprived of the means of subsistence, the only means of living is either to be beggar or thief. The society is not interested to see such bad effects to result from the bankruptcy proceeding. As a result, the creditors' interest to get the whole property of the debtor realized for their benefit is to be limited for the benefit of the society at large.

The *other* privilege of the debtor is to get employed so that the winding up process could be facilitated. Note here that the debtor is to be employed only in relation to the bankruptcy proceeding. You also need to note that this is just a privilege and not a right. Therefore, the debtor cannot demand as of right. The trustees can employ the debtor only on the basis of terms and conditions to be fixed by the commissioner. In other words, the debtor cannot demand the rights and privileges under the ordinary contract of employment. As the terms and conditions are to be fixed by the commissioner, they could be different from those of the ordinary contract of employment. For example, the debtor cannot claim the normal working hours in case the commissioner fixed nine hours a day. Therefore, it is a restricted privilege of employment depending on the terms and conditions to be fixed by the commissioner.

The *third* right or privilege of the debtor resulting from adjudication of bankruptcy is that outstanding debts of the debtor are to be rendered due. The debtor could be creditor of another debtor. Where his claim has not yet matured on the day of declaration of his bankruptcy, the declaration renders such debts to be due. For example, assume that Ato Mengesha is the debtor who is declared bankrupt. His bankruptcy was declared on June 1, 2005. He was creditor of W/ro Yeshe for the amount of 50,000 Birr. According to their contract, the debt becomes due on July 5, 2005. In this case, as a result of declaration of bankruptcy of Ato Mengesha on June 1, 2005, the debt is to be rendered due as of the day of declaration. Though the debt normally becomes due on July 5, 2005, the fact that Ato

Mengesha is declared bankrupt brings about maturity of such debt a month before the normal date of maturity. Read the provisions of Article 1027 of the Commercial Code.

*Art. 1027- Outstanding debts rendered due*

- (1) On adjudication all debts owing to the debtor shall become due immediately.
- (2) Debts expressed in foreign currencies shall be converted into local currency at the official rate of exchange on the day of adjudication.

The provisions of the Civil Code also regulate the rights of the creditor in case where time of performance of the contractual obligation is determined in the contract. Accordingly, where the debtor's insolvency is established, such debtor shall lose the benefit of time agreed in the contract. For better understanding, you are requested to read the provisions of Article 1868 of the Civil Code, which reads as follows:

*Art. 1868- Loss of benefit of time*

The debtor whose insolvency has been established or who has reduced the value of the securities given by him to the creditor shall lose the benefit of the agreed period of time.

The *fourth* privilege or right to result from adjudication of his bankruptcy is the right to be relieved from the payment of interest on the debts he owes others. Where the debtor is duty bound to pay interest on the debt he owes others, as of the day of declaration of his bankruptcy, he would not be obliged to pay interest. In other words, the fact that the debtor is declared bankrupt, quits the interest from running on the debts. But there is an exception to this right of the debtor. The interest is to continue to run in relation to debts guaranteed by security in *rem* (i.e. security in the form of pledge or mortgage where movable or immovable properties are to be produced to secure performance of the principal obligation). However, note here that the interests already run before the date of declaration of bankruptcy of the debtor is payable. It is only subsequent interest that

ceases to run and the interests preceding the date of declaration of bankruptcy remains the liability of the debtor.

### **C) Invalid Acts or Rights**

The adjudication of bankruptcy makes certain acts of the debtor invalid. Not only the acts of the debtor, but also rights registered before the declaration of bankruptcy are to be made invalid as a result of declaration of bankruptcy. Now let us discuss the acts first and then the rights in the.

**i) Acts prior to adjudication** Where the following acts have taken place before the declaration of bankruptcy of the debtor, as a result of the adjudication, they shall be invalidated.

- **Gratuitous assignments**

You know what gratuitous assignments are? I hope you remember from your knowledge of contract law. An assignment is called gratuitous where it is made without consideration or for no payment. Where one of the parties has transferred a right or property without claiming a return for it, that is what we call gratuitous transfer. Consequently, where the debtor has transferred a right or property without getting a return for it either in the form of price or service, the act shall become invalid as a result of the declaration of bankruptcy. There is justification to such invalidity in that the assumption is that the debtor entered into such gratuitous assignment transaction with the view of evading the bankruptcy proceeding. As the debtor got nothing from the party who acquires a right over the thing assigned, it seems that he did it so that he could evade the bankruptcy proceeding. This is more like a simulated contract which is not real.

- **Payments of debts not due**

There might be a number of instances where the debtor may become a debtor of other persons. Where he is debtor, normally, he is expected to make payments after the date of maturity. Where he made payments before the due date, that indicates something as if the debtor made such payment with the view of escaping the bankruptcy proceeding. As a consequence, the law invalidates payments of debts not yet due whether they are made in cash or by assignment, sale, set-off or otherwise. Note here that it is not only cash payments that are made before the due date, but also payments made in other forms are also to be invalidated as a result of the adjudication of bankruptcy of the debtor. For example, assume that Ato Damene is the debtor who is declared bankrupt. He was the debtor of Ato Asmelash to the extent of 50,000 Birr, which matures on June 2, 2005. He was declared bankrupt on May 5, 2005. In another transaction, Damene became the creditor of Asmelash to the extent of 40,000 Birr. Before the adjudication of his bankruptcy, Ato Damene agreed to set-off the debt he owes Asmelash and it was effected accordingly. The set-off took place on May 1, 2005. In this case, the act of the debtor to pay a debt, which is not yet due, shall be invalidated as a result of the adjudication of bankruptcy of Ato Damene. The law presumes the conduct of the debtor to be malicious.

- **Payments of debts due**

Where the bankrupt person is the debtor of another person, he is to pay the debt when it becomes due. In case the payment is made in cash, as we have discussed earlier, in principle, the rights acquired before adjudication are to be respected. As a result, the person who got payment before the adjudication of bankruptcy of the debtor can enjoy it without any problem. But an exception to the principle is where the payment is made not in cash but through negotiable instrument or bank transfer. Where the payment is made in cash, as money is easily transferable it could not be as such simple to trace it. But where the payment is made by issuing or endorsing negotiable instruments, one can easily trace it. The same is also true where the payment is made through bank transfer. As you know from your study of the Law of Banking, bank transfer is a service of the banks by which

they debit the account of one person by some amount of money and credit the account of another person to the same amount. Although it has already become due, the debt is paid before the date of adjudication of bankruptcy of the debtor. The payments are to be invalidated where they are made through negotiable instruments or bank transfer.

One can raise an issue in relation to payments made through negotiable instruments or bank transfer. Negotiable instruments are documents entitling the holder to the amount of money stated therein. As they represent the amount of money stated therein, what is the point of difference between payment made in cash and one made by negotiable instruments? In other words, what is the justification for invalidating payment of debts already due where it is made through negotiable instruments or bank transfers while payments made in cash are not so? Where a person has become a holder of a negotiable instrument, legally transferred to him, then he automatically gets entitlement on the amount of money specified therein. There is no way the drawee or maker could refuse to pay on the instrument.

- **Securities**

The properties of the debtor could be attached to secure the payment of debts of the bankrupt himself or that of other persons. As you know from your background knowledge of the Law of Security Devices, particularly pledge, a person can produce his property in the form of pledge either to secure payment of his own debt or the debt of another person. Where the properties of the debtor are produced in the form of security before the date of declaration of bankruptcy, such security shall be invalidated. Do you think that it is all transactions of security that are to be invalidated? I hope your answer is “No”. If you answered so, you are right. It is not all securities set up on the properties of the debtor that is to be invalidated. It is only securities set up fifteen days before the date of declaration of bankruptcy. The debts should be those contracted within fifteen days between the date of suspension of payments and the date of adjudication of bankruptcy.

- **Acts after suspension of payments**

As we have discussed earlier, where the obligations of the debtor, which he owes his creditors, are due, he is expected to pay them. However, it may not always be considered proper whenever the debtor pays such obligations. Where he has already suspended payments, even if his bankruptcy is not yet adjudicated, the debtor could make payment of debts. As a result of the declaration of his bankruptcy, the payments made after the date of suspension of payments could be invalidated. Not only the payments he made, but also all acts for consideration that are entered into after the date of suspension of payments shall be invalidated as a result of the adjudication of bankruptcy of the debtor. Such acts shall be invalidated only where there is request on the part of the trustees. One may raise an important issue in relation to the right of request of the trustees; that is, on what ground can the trustees request the acts to be invalidated? I hope you have tried to enumerate some grounds. If you did so, that is great. As per the provisions of Article 1030 of the Commercial Code, the trustees can request for invalidation of payments or other acts for consideration that took place after the date of suspension of payments, where the parties who have received payment or have dealt with the debtor did so knowing that suspension of payments had taken place. In other words, the existence of bad faith on the part of the parties who dealt with the debtor is a ground for the trustees to request invalidation. You can read the said provisions, which read as follows:

*Art. 1030- Other acts prior to adjudication may be invalidated*

Other payments made by the debtor in respect of debts due and all acts for consideration entered into by the debtor after the date of suspension of payments may be invalidated on the request of the trustees where the parties who have received payment or have dealt with the debtor did so knowing the suspension of payments had taken place.

## **ii) Rights Invalid**

As we have discussed earlier, the properties of the debtor could be produced in security to guarantee performance of certain obligations of the debtor himself or another person. The property to be produced in security could be either movable or immovable. Where the property is movable, we have seen that the security could be invalidated where the act took place within fifteen days between the date of suspension of payments and the date of adjudication of bankruptcy. But what if the property is immovable? In such a case, a security could be registered on them until the date of adjudication of bankruptcy. Where it is so registered, the right of persons in whose favor the registration is made can enjoy it.

However, where registration of the security in rem has taken effect after suspension of payments or one month before suspension of payments, it could be invalidated. Note here that the registration to be effected by the trustees in discharge of their functions is not subject to invalidation. In order to serve as a ground for the invalidation, it is to be checked that more than one month period lapsed between the date on which the act creating the security and the date of registration of the security. In other words, the registration should have taken place promptly after the act creating the security has taken place. If there is delay up to a month or more periods and later the debtor effects such registration after the date of suspension of payments, the assumption is that he did it with the view of evading the interest of the creditors.

As far as the rules of negotiable instruments are concerned, the holder of an instrument has the right of recourse against all the parties to the instrument. In order to exercise his right of recourse, the holder is expected to comply with three requirements namely presentment, protest, and notice. He should present the instrument either for payment or sight in due time. After it is presented, the instrument may be refused to be paid by the drawee. In such cases, the fact that the drawee has refused and rejected the instrument has to be evidenced by a protest to be produced by a competent authority. After getting the protest the holder has to give notice to the parties to the effect that the instrument is not

paid by the drawee. As far as he has complied with all these prerequisites, the holder can bring action against any of the parties to the instrument jointly or severally.

When it comes to the situation of bankruptcy, the holder has no right to proceed against all the parties to the instrument. As you read in the provision cited above, the holder can proceed against the third party who has first received the value of the instrument. Where the instrument has been endorsed subsequently to other persons, the party who shall be liable on it is only the one who first received the value of the instrument. For instance, assume that Ato Gebre is declared bankrupt. Between the date of his suspension of payments and the date of declaration of bankruptcy, he made payment of debt by issuing a cheque on his bank. The cheque was issued in favor of Ato Alemu, who was one of the creditors of Ato Gebre. After receiving the cheque, Ato Alemu endorsed it to W/ro Meselech, who in turn endorsed and transferred to Ato Molla. The latter also endorsed and transferred the cheque to W/ro Tayech, who is finally the holder. The payment through the cheque made by Ato Gebre was invalidated because it was made after the date of suspension of payments. As a result the trustee can enforce reinstatement of the payment as the effect of invalidation is to reinstate the parties to their previous position. In this case, the trustee can proceed only against Ato Alemu because it is him who first got the value of the instrument (cheque). When he transfers the cheque to W/ro Meselech, it is for consideration. It could be because he bought some property from her or because he discharged a money debt he owes her or due to another reason. The trustee has no right to proceed against the endorsers or the drawee bank, even if the latter has refused after it has certified the cheque. Though the endorsers also have received the value of the cheque, it seems that the law assumes that there is no direct relationship between them and the bankrupt person.

Now read the provisions of Article 1033 of the Commercial Code:

*Art. 1033- Negotiable instruments paid after suspension of payments*

- (1) Where negotiable instruments have been paid between the date of suspension of payments and that of adjudication, proceedings for

reimbursement of sums so paid may only be instituted against the third party having first received the value of the instrument.

- (2) In the case of a promissory note, such proceedings may only be instituted against the first endorser.
- (3) The claimant under sub-art. (1) or (2) shall prove that the party against whom the proceedings are instituted knew of the suspension of payments at the time of payment of the instrument.

Could there be instances where the party who received the value of the instrument is different from the one on whose favor the instrument is issued by the bankrupt person? I hope your answer is “Yes”. If so, you are correct. You see, where the person, on whose benefit the bankrupt issued the instrument, has endorsed and transferred the instrument to another person without receiving its value then he would not be the one against whom the proceeding could be instituted. There might be several reasons why the person could gratuitously transfer the instrument without consideration. In that case, the one who first receives the value of the instrument is another person than the one in whose favor the instrument is issued.

The above discussed rules of law do not apply in the case where the payment is made by a promissory note. In such cases, the proceeding could be instituted against the person who first endorsed the instrument. I hope you know the characters of a promissory note as compared to the other types of commercial instruments. In the case of promissory note, there is no drawee ordered to pay on the instrument. Rather it is the maker who enters into commitment to pay on the instrument on maturity and presentment. Therefore, whether the person in whose favor the promissory note is made has endorsed and transferred it for value or otherwise, it is him against whom the proceeding could be instituted. Unless the instrument is transferable without endorsement, he could not escape from liability. But where the promissory note is still in his hands and therefore is not endorsed, there is no situation where such person is to be liable.

In order to succeed in his proceeding against the parties discussed in the previous paragraphs, the one who instituted the proceeding has to prove that they knew the fact that the debtor has suspended payments. As the person declared bankrupt makes payments by negotiable instruments after the date of suspension of payments, if the party has received payment with the knowledge that the one who pays to him has already suspended payments and is at the verge of declaration of bankruptcy, it indicates bad faith on the part of the party receiving payment.

When do you think that actions for the invalidation of the acts or rights discussed above should be instituted? You might have tried to guess the time within which an action should be brought. If so, that is great. As per the provisions of Article 1034 of the Commercial Code, all actions to invalidate the acts of the debtor made prior or later to the date of adjudication should be brought within two years period from the date of adjudication. If no action is brought within the two years period after the date of adjudication, the act or right shall be considered as valid. Any proceeding brought after the two years period shall be barred by limitation. This has the effect of validating the acts of the debtor made prior or later to the date of adjudication.

### **2.2.2. Effects as regards the Creditors**

In the preceding section, we have been discussing the effects of adjudication of bankruptcy as regards the debtor. The adjudication of bankruptcy brings about different effects as regards a particular creditor or all of the creditors collectively. Now, we are going to discuss the different effects of adjudication as regards the creditors.

The effects are provided under the provisions of Articles 1024-1026 of the Commercial Code. We can divide the effects into three categories, namely, legal proceedings, universality of the creditors, and suspension of individual suits. Now let us discuss each of these effects in the .

## **A) Legal Proceedings**

After the adjudication of bankruptcy, there might be matters in relation to which an action could be brought. As a result of adjudication of bankruptcy, all legal proceedings to be brought against third parties, which are related to the bankruptcy proceeding, shall be managed by the trustee/s. In other words, the creditors have no right to bring actions against third parties. It is the trustee/s who can institute all legal proceedings related to the bankruptcy proceeding.

The creditors are also not entitled to defend applications made for execution. It is only the trustee who can respond to applications for the execution of a certain right or claim related to the bankruptcy proceeding. In fact, the trustee/s may require the bankrupt person to intervene in the proceedings.

## **B) Universality of creditors**

As a result of adjudication of bankruptcy, there would be no situation where a single creditor promotes and enforces his claims separately. Rather, the adjudication brings all the claims of the creditors together and forms the universality of creditors. The universality of creditors of the bankruptcy is a legal person created by the operation of law. It is a juridical person or commonly known as artificial person. As it is a legal person, it acquires rights and incurs liabilities like a physical person. As it is a fictitious person, one may question as to how the universality acts. Have you tried to answer the issue? If so, that is great. The universality, being an artificial person, is to be represented by the trustees. Therefore, there is principal-agent relationship between the universality and the trustees.

One may raise an important issue as regards the universality of creditors of bankruptcy. Is it all categories of creditors that are to join the universality of creditors? In order to

answer this question, now read the provisions of the following Article from the Commercial Code:

*Art. 1025- Universality of creditors in bankruptcy*

- (1) As from the day of the judgment in bankruptcy, all creditors whose claims are not secured by a special privilege, a pledge or a mortgage, shall bring their claims together in the universality of creditors in bankruptcy.
- (2) The universality is a legal entity. It may acquire rights or incur liabilities and shall be represented by the trustee.

It is not all categories of creditors that form the universality. As you read from the above cited Article, it is creditors whose claim is not secured either by movable or immovable properties. Creditors, who have special privilege in relation to the person declared bankrupt, can also not join the universality. Therefore, it is only the unsecured creditors who can join the universality. Then what do you think is the rationale behind this discrimination? You might have guessed the reason for such discrimination. As regards creditors, who got a property of the debtor in the form of security for the payment of debts, they have something in their hands to satisfy their respective claims. As they have something in their hands, they would not be as careful and alert as the creditors who have no security. Therefore, it would not be fair to treat both categories of creditors similarly.

**C) Suspension of individual suits**

Sometimes, it may happen that the bankruptcy of the debtor may be declared after the creditor has brought action individually. While the case is pending, if the debtor is declared bankrupt, the creditor would not continue with the case. Adjudication of bankruptcy suspends such suits. But do you think that all pending cases are to be suspended as a result of the adjudication? I am sure that you answered “No”. It is the case of a creditor whose claim is included in the universality that is to be suspended. In other

words, it is the suit of unsecured creditors that is to be suspended as a consequence of the adjudication of bankruptcy. Read the following Article from the Commercial Code.

*Art. 1026- Suspension of individual suits*

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

As a consequence of adjudication of bankruptcy, the creditors are also to lose the right to attach properties of the debtor. The only means for such creditors is to satisfy their claims by participating in the bankruptcy proceeding of the debtor.

The provisions of Articles 1025 and 1026 of the Commercial Code are in line with the principle of collective enforcement. This principle provides that all the creditors have to be put at equal footing as far as their respective claim against the debtor is concerned. In other words, there should be no discrimination among the unsecured creditors. No creditor is to be allowed to promote and enforce his claim separately. This seems to have taken into account situations where some of the creditors have better access and activeness to find the debtor and thereby satisfy their respective claims, while others are not as such active and have access. In such cases, the available resources of the debtor would be left for the benefit of only some of the creditors. The others, even if they have valid claim against the debtor, are to lose. To avoid such and other risks, all the creditors are to enjoy the available resources of the debtor appropriately and fairly.

### **2.3. Administration of Properties of the Debtor**

Earlier, we have discussed that after inventory is made, all the documents, papers, and properties of the debtor are to be handed over to the trustees. As administration of the properties is within the power limits of the trustees, the documents and properties are to be handed over to them. Management of properties of the debtor is also within the power

limits of the trustees. In this section, therefore, we are going to discuss the functions of the trustee in the management of properties of the debtor.

There are several activities to be performed by the trustee in discharging his responsibility of managing the properties of the debtor. The trustees are to discharge these responsibilities with the assistance of the commissioner and the court, as the case may be. The overall purpose of the bankruptcy proceeding is to keep the properties of the debtor properly, to sell them and to distribute the proceeds among the creditors. In order to achieve these objectives, the trustee is expected to perform various activities, namely: to sell the properties and the business, to enter into compromise and arbitration, to collect debts, to continue the business, and to cancel or continue a lease relationship. These are not the only functions, but the major ones. Now let us discuss each of these functions of the trustee briefly.

### **Sell Properties or Business**

As we discussed repeatedly, the overall purpose of the bankruptcy proceeding is to collect the properties of the debtor and realize them for the satisfaction of claim of the creditors. The trustees, therefore, are responsible for the sale of properties of the debtor. In effecting sale of properties of the debtor, the trustees are first to sell only some of them. It is not all types of properties that are to be sold, but the properties that can perish within a short period of time or those which depreciate within a short period of time. I hope you know depreciable and perishable goods. They are properties that get spoiled in a very short period of time so that they could go out of use while depreciable goods are those which wear out within a short period of time.

The trustees are also expected to sell properties the preservation of which is costly. Some of the properties may have a nature of incurring much cost than their value. For instance, there may be a container that takes wide space and costs much for up keeping, while its value is by far less than such cost. In such cases, it would not be proper if the trustees wait for the sale of such properties along with others the preservation of which is not as

such costly. Where it is to be waited for such time, the estate would incur much liability just for the preservation of the property. As a result it may affect the interest of the creditors in that the money to be distributed among them is to be paid for preservation of the property. For example, assume that a certain property is identified to have much more cost for its preservation. While its value is 3,000 Birr, to keep it in a warehouse, the cost is 7,000 Birr. In this case, the 7,000 Birr which would have been distributed among the creditors, is to be paid for preservation in a rental warehouse.

Do you think that the trustees are to sell the perishable and depreciable properties or properties that the preservation of which is costly at their own discretion? I am sure that you answered “No”. If you answered so, that is correct. As we have discussed earlier, the trustees are to discharge the functions of management of properties of the debtor with the assistance of the commissioner and the court. In the case of sale of the above-mentioned types of properties, the trustees are required to secure permission of the commissioner to that effect. Otherwise, it would not be proper if the trustees sell the properties simply based on their reasoning or decision, which may at times be harmful.

Next to perishable or depreciable properties, the trustees are to sell the other movable properties or goods of the debtor. Before selling such properties or goods, the commissioner has to hear the debtor. Why do you think that the law gives such opportunity for the debtor, while the same is denied at the time of sale of perishable or depreciable goods? You might have tried to guess the rationale behind such permission. Sometimes, the properties may not be related to the business activities of the debtor or they may be things acquired as result of succession or donation. Where the property is something, of sentimental value, acquired from the forefathers of the bankrupt person through succession or donation and where they are not replaceable by purchase from the market, such facts can be disclosed only where the debtor is given a chance to be heard. As regards the depreciable or perishable goods, it would not bring about benefit if the debtor is heard, because the only solution would be selling them within a short period of time. Otherwise, they will go out of use, totally or partially.

After hearing the debtor, who may show up by his own initiative or because of a summons from the commissioner to that effect, it is within the power limit of the commissioner to decide whether a certain movable property or good of the debtor should be sold or not. Where he finds the properties or goods to be sold, the commissioner authorizes the trustees to effect the sale. In all cases, the sale is to take place in accordance with the conditions to be set by the commissioner. This indicates that the trustees cannot sell the properties or goods simply based on the market situation or other normal circumstances. For example, where the commissioner has set a condition that the property or good of the debtor should not be sold to some category of people (for instance, public servants), then the trustees could not sell the property or good to them. The same will be true if the commissioner fixes the minimum price for the sale of the properties.

The trustees are also to discharge the responsibility of sale of the business of the bankrupt person. As regards sale of business, do you think that the permission comes from the commissioner? You might have tried to answer the question. Now try to compare your answer with the following Article from the Commercial Code.

*Art. 1037- Sale of bankrupt person's business*

The sale of a business by the trustees may only be permitted by the court and the court shall fix the conditions of the sale.

As per the above cited Article, sale of the business of the debtor would be effected on the permission of the court. All matters related to the business of the debtor are within the power of the court. Whether the business should continue or not is to be decided by the court. Similarly, the sale is to be determined by the court and, therefore, the trustees are expected to sale based on the conditions set by the court. As a consequence, the court may fix the minimum price or the time of sale of the business and so on.

## **Compromise and Arbitrate**

In the process of managing the properties of the debtor, the trustees may enter into compromise or arbitration. Sometimes, the action of selling the properties may not be advantageous to the bankrupt estate. As a result, compromise or arbitration could be found appropriate so that the properties or goods could be appropriately managed. Whenever it is found proper, the trustees can enter into compromise or arbitration.

Do you think that the trustees can enter into compromise or arbitration as it pleases them? I hope your answer will be “No”. If you answered so, that is great. In order to compromise or arbitrate, the trustees should secure permission of the commissioner. Unless they get authorized by the commissioner, the trustees cannot enter into compromise or arbitration. However, you have to note here that the trustees are to be authorized to compromise and arbitrate only as regards matters related to the bankrupt estate, and no other.

The commissioner is also not haphazardly to determine whether the trustees should enter into compromise or arbitration. Before such determination, there should be hearing of opinion of the creditors’ committee and the bankrupt person. Why do you think the opinion of the creditors’ committee necessary before such authorization? As we have discussed earlier, the creditors’ committee has an advisory role on matters related to the bankrupt estate. As you know, in the case of compromise or arbitration there is mitigation and submission of some of the rights or privileges. In order to preserve certain rights or privileges of the bankrupt person and thereby that of the bankrupt estate, the trustees are to submit and compromise some rights or privileges. It is a kind of give and take principle. Where they involve in such business, it is necessary to hear the opinion of the creditors’ committee as well as that of the bankrupt person.

At the time of hearing opinion, the bankrupt person may present himself by his own motion or because of summons to be made by registered letter. After hearing opinion of the committee or the bankrupt person, the commissioner may get convinced that it would

not be proper to enter into compromise and arbitration. In such cases, he will order no arbitration or compromise to be entered. But where the committee as well as the bankrupt person is convinced that it will be advantageous to the bankrupt estate if the trustees compromised and arbitrate, then the commissioner can authorize such arbitration and compromise.

Sometimes, the matter of compromise and arbitration may be beyond the power limits of the trustees. What do you think happens in such cases? Where the matter goes beyond the power limits of the trustees, it would not be the power of the commissioner to give permission and authorize the trustees. Both the trustees and the commissioner are appointees of the court. The commissioner has no mandate to confer power on the trustees, though the former is to supervise the latter. Therefore, it is the court that can authorize the trustees to compromise and arbitrate on matters of the bankrupt estate beyond their scope of power. For example, as we discussed earlier, all matters in relation to the business of the bankrupt person fall within the power limits of the court. Where the compromise and arbitration is related to the business of the bankrupt person, the trustees have to get authorization from the court. Unless the court ratifies such compromise and arbitration, it would be *ultra-vires* (in excess of power) as far as the power of the trustees is concerned.

The bankrupt person should be given the opportunity to attend the ratification proceeding. It could be wrong to conclude that the trustees are always to request the court to ratify arbitrations and compromises that are absolutely correct. Sometimes the ratification may be requested as regards matters that adversely affect the interests of the bankrupt person or the creditors. It is where the bankrupt person is given the opportunity to be present at the time of ratification that he could be able to present such matters. Not only the bankrupt person but also the creditors' committee representing the creditors should be present at the time of the ratification proceeding. However, the law is silent about presence of the committee while it has provided expressly for the presence of the bankrupt person. You can read the provisions of Article 1038 of the Commercial code, which reads as follows:

*Art. 1038- Compromise and arbitration*

- (1) After taking the opinion of the creditors' committee and after hearing the bankrupt, whether he presents himself of his own motion or on being summoned by registered letter, the commissioner may authorize the trustees to compromise and arbitrate in respect of any claim concerning the bankrupt estate.
- (2) Where the value of the subject matter of the compromise or arbitration is not determined or exceeds the jurisdiction of the trustees, the compromise or arbitration shall be ratified by the court.
- (3) The bankrupt shall be summoned to attend the ratification proceedings and may make an application to set aside the compromise or arbitration.

Where he finds something to affect his interests, the bankrupt person can raise before the court that such things be rectified. Otherwise, the bankrupt person can apply for the setting aside of the compromise and arbitration. Where the court finds the application of the bankrupt person valid and justifiable, it can order for the setting aside of the compromise and arbitration.

### **Collect Debts**

As we discussed earlier, the bankrupt person is to be represented by the trustees. From the date of declaration of bankruptcy, he loses the right to administer his properties and also the right to dispose his properties. The restriction of dealing with the properties includes the loss of right to collect claims from the debtors. There might be a number of instances where the bankrupt person is the creditor of other persons. Where the bankruptcy is declared before the debts are collected by the bankrupt person, it is the responsibility of the trustees as agents of the bankrupt person to collect the debts. For example, assume that W/ro Tilaye is declared bankrupt. Before declaration of her bankruptcy, she entered into several transactions with Ato Fantu, Ato Girma, and Ato

Tessema. As a result of these transactions, Ato Fantu is indebted to W/ro Tilaye to pay 10,000 Birr; Ato Girma to the extent of 50,000 Birr; and Ato Tessema indebted to the extent of 40,000 Birr. Unfortunately, W/ro Tilaye was declared bankrupt before these debts are paid by the respective debtors. In this case, the trustees of the bankruptcy of W/ro Tilaye shall collect the debts from each of the debtors. As they are representatives of the bankrupt person and are responsible to discharge the function of managing the properties of the debtor, the trustees shall collect the debts.

### **Continue Business**

The court may order the business of the bankrupt person to continue even if adjudication of bankruptcy is made. There might be several reasons why the court may order the continuity of the business while the debtor is declared bankrupt. For instance, the court may find public interest highly attached to the business of the bankrupt person. This may happen where the business is the only producer or supplier of basic goods to the community. While there is a bulk deposit of such goods the business produces or supplies, it is better if the court orders for continuity of the business for a certain defined period of time. If the court orders for non-continuity and sale of the business, that would adversely affect public interest. With the view of protecting the public interest, the court may order for continuity of the business.

The court may also order for the continued operation of the business of the bankrupt person with the view of protecting interests of the creditors. For instance, assume that if the business continues to operate after the date of adjudication of bankruptcy, there will be high amount of profit to be gained. In such cases, it is to the advantage of the creditors if the business continues to operate. Where the court comes to get convinced that the creditors will be advantaged from the continued operation of the business, it can order for such continuity.

Where the court has ordered for the continuity of the operation of the business, the responsibility to discharge such function would be that of the trustees. As it forms part of

management of properties of the debtor, the trustees are to involve in the operation of the business. Before it authorizes the trustees, the court is to look into report of the commissioner and recommendation of the creditors' committee. There may be applications presented to the commissioner on matters related to the business of the debtor. The court has to consider such applications or other matters related to the business to come from the commissioner. As it has advisory role on matters related to the interest of the creditors, the creditors' committee's recommendations should also catch attention of the court. Where it finds merit in the recommendations of the committee or the report of the commissioner, the court has to withhold the order of continuity of the business. However, it has to be noted that in all cases, the court has to consider the public interest and interest of the creditors.

Where the business continued due to public interest or interest of the creditors, new creditors may be created as a result of different transactions. While it is the trustees who operate the business since the bankrupt person is denied the right to deal with his properties, who shall be liable to discharge the liability towards such creditors? As we have discussed earlier, the claim of all the creditors joins together and forms the universality of creditors. All debts to arise out of the continued operation of the business shall be debts of the universality of creditors in bankruptcy. Read the provisions of Article 1039(2) of the Commercial Code.

*Art. 1039- Continuation of operation of business*

- (1) The trustees may continue operating the business or industry where authorized by the court after a report by the commissioner and a recommendation of the creditors' committee, and authorization shall not be given unless it is in the public or creditors' interest.
- (2) Where the business continues to operate, creditors whose claim has arisen out of such operation shall be creditors of the universality. They shall not be subject to the provisions regarding bankruptcy and shall be paid from the assets of the bankruptcy before the creditors whose claims are included in the universality.

(3) Instead of operating the business himself, the trustee may be authorized by the commissioner to appoint a receiver to carry on the business.

As provided under sub-article (2) of the above cited Article, the creditors who acquire a right as a result of continued operation of the business shall become creditors of the universality of creditors. Normally, the principle under bankruptcy provisions is that it is only rights of creditors who acquired it before adjudication that is to be respected. A right acquired after the date of adjudication of bankruptcy of the debtor would not be protected and therefore, a creditor of such rights can not succeed if he claims from the bankrupt estate. As a result neither the bankrupt person nor the bankrupt estate is responsible to discharge liabilities towards subsequent creditors. However the business operates and creditors are created from such continuation, the universality shall be liable.

The creditors of the debt arising from the continued operation of the business are not to be subjected to the provisions of bankruptcy. In other words, they are not to be governed by the provisions of bankruptcy in that they are not to stand along the other creditors of the bankrupt person. Their claim would not go into the universality; rather the universality becomes their debtor. As a result, such creditors are to be paid from the assets of the bankruptcy in priority to the other creditors. The creditors, who acquired their rights before the date of adjudication of bankruptcy, whether they are preferred, secured or unsecured, would get after such creditors have got payment in priority.

The trustee may not be all-rounded person, i.e, a good businessman. Where he is not a good businessman he could not cope up the market situation, particularly in a competitive situation. To let such trustee to swim in the middle of an ocean without a rescue team will be disadvantageous to the creditors. In such cases, the commissioner may authorize the trustee to appoint appropriate person/s to carry on the business. Business is not as such a simple task as it requires skill and knowledge in properly managing the ins and outs. Otherwise, the interest of the bankrupt person as well as the creditors will fall at stake.

## **V) Cancel or Continue Lease**

Before adjudication of his bankruptcy, the bankrupt person might have taken the immovable of another person on a lease basis. The immovable could be leased for use in relation to the business of the bankrupt person. Where there is such a relationship, the mere fact that the lessee is declared bankrupt would not bring an end to the relationship of lease. The same holds true even if the immovable forms part thereof or is the premises held by the bankrupt person or his family. If the lease relationship is not to come to an end on declaration of bankruptcy of the lessee, the question remains as to what would happen to such relationship.

What do you think happens to the relationship of lease? Have you tried to answer? If so, that is great. As per the provisions of Article 1040(2) of the Commercial Code, the trustees are empowered to decide on the fate of the relationship. Accordingly, the trustees have two options: to terminate the lease relationship or to continue with the relationship. There is no standard expressly provided by the law under which the trustees can decide either to cancel or terminate the lease relationship. It seems that the trustees have discretion to decide on the matter.

However, it has to be noted that the trustees cannot simply enforce their decision regarding the lease relationship. They are expected to secure consent of the creditors' committee and the commissioner. Whatever the decision of the trustees may be, they have to give notice to the lessor. Such notice should be given to the lessor within fifteen days from the date of deposit of the inventory of properties of the debtor, along with the list of preferential creditors. Irrespective of the decision of the trustees, the notice of such decision has to be given only where they have got recommendation of the creditors' committee and authorization of the commissioner.

In the period of time within which notice is to be given, the movable properties used for furnishing the business or the industry would not be made subject to seizure with the view of getting payment of debts. It is also not allowed to cancel the lease relationship

within the notice period. The fifteen days period is a period of notice to the lessor. However, the lessor can take possession of the premises within such period of notice. In such cases, the restriction on seizure would be lifted and the movable properties used to furnish the immovable could be seized with the view of getting payment of obligations. Where the lessor has got possession of the premises, the movable properties used for the business or industry are to be considered not related to the lease relationship. As the lease relationship comes to an end by possession of the premises by the lessor, nothing would prevent from exercise of distraint.

Where the trustees have decided to continue the lease relationship, who discharged obligations towards the lessor? I am sure that your answer is “The trustees themselves”. If your answer is so, you are correct. It is obvious that the previous lessee is declared bankrupt and as a result lost the right to deal with properties in his possession. The bankrupt person (the previous lessee) is to be represented by the trustee. Therefore, it is the trustee who should discharge obligations related to the lease relationship. The lessor can demand the rent from the trustees. Where there is agreement to the effect that the lessee shall repair where a need arises, the lessor can request the trustees to discharge such obligation.

Do you agree that the lessor would have no anything to say in the continuity or cancellation of the lease? I hope you will answer “No”. If your answer is so, that is wonderful. The mere fact that the trustees have decided to continue the lease and have given notice to the lessor to that effect would not necessarily guarantee continuity of the lease. The lease is to continue only where the lessor has failed to react to the notice within fifteen days from receipt of it. This implies that where the lessor has refused to continue the lease relationship and applies to the court for cancellation of the lease, it would not continue. Here it seems clear that the freedom of the lessor to choose his contractant party is reserved. As he entered into the lease contract while the lessee was not declared bankrupt, he should not be forced to continue with such relationship after he came to know the fact the lessee is adjudicated bankrupt. There is always a risk if one continues in contractual relationship with a person adjudicated bankrupt. Therefore, what

is prohibited is to cancel the lease relationship automatically where one of the contracting parties is declared bankrupt. A period of one month, as a period of notice, has to be given and thereafter the fate of the relationship decided. Where the lessor is willing to continue with the lease relationship, despite the existence of risk, then it is appropriate that he claims rights from the trustees. Note, however, that a stipulation to the effect that the lease relationship shall automatically come to an end on adjudication of bankruptcy of one of the parties shall have no effect (Read Article 1040 of the Commercial Code).

*Art 1040- Continuation of lease*

- (1) Leases of immovable property used for the business or industrial operations of the debtor, including premises forming part thereof and occupied by him or his family, shall not be cancelled by reason of the lessee's bankruptcy.
- (2) The trustees may either cancel or continue the lease and shall give notice to the lessor of their decision within fifteen days from deposit of the inventory as provided in Art. 1044. Where the trustees continue the lease, they shall carry out the duties of a lessee.
- (3) Notice may not be given except on the recommendation of the creditors' committee and with the authorization of the commissioner.
- (4) Until the expiry of the period mentioned in sub-art. (2), movable property used for the business or industry shall not be distrained upon nor shall lease be cancelled, without prejudice to provisional measures and the right of the lessor to take possession of the premises. Where the lessor takes possession of the premises, distraint is effected.
- (5) Where the trustee has informed the lessor of his intention to continue the lease, the lease shall continue unless the lessor applies for a cancellation of the lease within fifteen days.
- (6) A clause in the lease providing for immediate cancellation of a lease in the event of a bankruptcy shall be of no effect.
- (7) Nothing in this Article shall affect the provisions of Art. 1061 and 1062.

In cases where the lease is terminated because of the decision of the trustees for good reason, the lessor would enjoy preference. The preference shall be in respect of all claims arising out of the performance of the contract of lease and contingent damages. It is not for all the previous times of lease relationship that the preference is to be given. It is only for the two years of the lease prior to the adjudication of bankruptcy and for the current year. For instance, assume that there was a lease relationship between the bankrupt person (W/ro Chaltu) and Ato Mulugeta (the lessor) for the past five years. W/ro Chaltu was declared bankrupt on July 10, 2005. Since the last four years no rent was paid by the lessee (W/ro Chaltu). During the bankruptcy proceedings of W/ro Chaltu, the trustees decided to terminate the lease relationship by cancellation. As a result of such termination, Ato Mulugeta would be entitled to enjoy preference in respect of the rents and contingent damages of the two years before the date of adjudication and the current year. As a result, the lessor would get preference to get the unpaid rents and contingent damages of the years 2003, 2004, and 2005.

What if the lease relationship is not terminated? As per the provisions of Article 1060 of the Commercial Code, it all depends on whether the lessor has got payment of all the rents due or not. If he has got payment of all the rents due, he cannot claim payment of the current period's rent and any rent to fall due in the future. This is where the guarantee given at the time of making of the contract of lease is still in force or those given since the adjudication of bankruptcy are considered to be sufficient. But where the rents due are not paid, the lessor can enjoy the preference as discussed in the preceding paragraph.

Where they have decided the lease relationship, the trustees are under obligation to keep the premises furnished with movables of sufficient value. It is possible that the lease relationship continues for the unexpired period. For instance, assume that initially the contract of lease was entered for a period of five years. After two years from the date of contract of lease, the lessee is declared bankrupt. As a result, the trustees have decided to continue the lease for the remaining three years period. That is the unexpired period as per the contract. Therefore, the trustees may continue themselves or assign the right to another person. Whether it is the trustees or an assignee who continues with the lease

relationship, there is a duty to furnish the premises with movables of sufficient value. It is also the duty of such person to carry out all the obligations arising out of the law or the agreement. Moreover, the person who continues with the lease should not change the purpose for which the premises are utilized. Now you are requested to read Article 1062 of the Commercial Code.

*Art. 1062- Continuation or assignment of lease by trustees*

The trustees may continue or assign a lease for the expired period, provided that they or the assignee shall keep the premises furnished with movables of sufficient value and carry out at the expiry of each letting period all obligations arising out of the law or the agreement, and provided further that the purpose for which the premises are utilized may not be changed.

## **2.4. Enforcement of Judgment**

As we have discussed earlier, the judgment of bankruptcy of a debtor could be passed in any of the three grounds, i.e., on petition presented by the authorized persons, on cancellation of the registry from the commercial register, or on death of the debtor. Whatever the ground for judgment may be, as an effect of the judgment in bankruptcy, a commissioner and trustee are to be appointed to carry on the bankruptcy proceeding. The commissioner is a person to be appointed by the court to supervise and deal with all matters in relation to the bankrupt estate. The trustee is mainly responsible for the administration of the properties of the debtor. Therefore, it is automatic that the judgment in bankruptcy of a given debtor results in the appointment of the commissioner and the trustee.

Do you think that the judgment in relation to bankruptcy of the debtor is to be enforced permanently? If you answered “No”, well done! Normally, as you know judgments and decrees of ordinary courts shall be enforced permanently. But where there is an application to the effect that the execution should be delayed or suspended, it remains unexecuted until otherwise order is passed. As regards bankruptcy proceedings, where

the court has passed a judgment to the effect that a debtor should be declared bankrupt, all the judgments and orders should be enforced provisionally. Read the provisions of Article 982 of the Commercial Code.

*Art. 982- Enforcement of judgments*

All judgments and orders in bankruptcy shall be enforced provisionally.

As you read from the above provision, the enforcement of all the judgments and orders in relation to bankruptcy shall be temporarily rather than permanently. An important issue could be raised as regards the rationale behind provisional enforcement of the judgments or orders. Can you guess why provisional enforcement rather than permanent enforcement? If you did that is great. The important reason why the judgment and orders are to be enforced provisionally is because of the possibility of setting aside the judgment.

An application could be made for setting aside the judgment in bankruptcy. The provisions of Article 984 of the Commercial Code provide the time within which the application could be made and the persons not entitled to make such an application. Read Article 984:

*Art. 984- Application to set aside judgment*

- (1) An application to set aside a judgment in bankruptcy shall be made within eight days from the date of such judgment. In respect of judgments subject to posting and to insertion in newspapers empowered to publish legal notices or in the official Commercial Gazette, the period of time shall run only from the date when the last requirement has been satisfied.
- (2) An application to set aside may not be lodged by the petitioner.
- (3) An application to set aside lodged by the debtor shall not suspend judgment.

The period within which the application to set aside could be presented depends on whether the judgment is to be publicized through newspapers or otherwise. Where it is to be publicized through newspaper or official commercial gazette, the application has to be made within eight days from the date of such publication through a newspaper or the official commercial gazette. But where there is no such a requirement that the judgment has to be publicized through insertion in the newspaper or official commercial gazette, the application to set aside has to be presented within eight days from the date the judgment is passed.

As per the provisions of sub-art (2) of the above Article, the petitioner is prohibited from presenting application for the setting aside of the judgment. Can you guess why the petitioner should not make application to set aside? You might have thought different reasons why he should not apply. The major reason why he should be prohibited is because it was he who presented the petition. Where the judgment resulted from petition, the demand for the declaration of bankruptcy of the debtor may come from the creditor. Even in cases where the judgment resulted from retirement or death of the debtor, once the petitioner has presented petition to the effect that the debtor should be declared bankrupt, it was his interest that the judgment be passed. While he had such an interest and the judgment is passed in accordance to with such interest it would not be fair to give again a chance to the petitioner to apply for the setting aside. If he again applies to set aside, he gets a chance just to play havoc in the life of the debtor. It was his interest to see the debtor declared bankrupt. Once that interest is fulfilled, it will not be proper to let him promote another interest.

The provisions of sub-art (3) of the same Article provide that an application to set aside made by the debtor himself should not suspend the judgment. What do you think is the rationale behind this provision? You might have mentioned different justifications. The main reason could be that as the judgment is made based on evidences, the probability that the debtor can succeed in his application to set aside is less. Where there is less probability, if the debtor is given a chance to get the judgment suspended by mere application to set aside, that can pave a way for improper acts on the part of the debtor.

For instance, if the judgment is to be suspended as a result of an application made by the debtor, the trustees could not start their function and the debtor can enter into different transactions that can affect the interests of the creditors. With the view of not letting the debtor to enter into such transactions, the judgment shall not to be suspended as a result of an application made by the debtor. Where it is found that the judgment has to be set aside, the enforced judgment would be set aside and the parties could be reinstated to the possible extent.

Do you agree that setting aside of a judgment is similar to review of judgment by the court of rendition under the civil procedure? Did you answer “Yes?” If your answer is so, you are correct. Setting aside is similar in that it is the same court that sets aside its own judgment. In the case of review by the court of rendition the same court revises its own decision where the necessary conditions are fulfilled. As you know from your study of Civil Procedure Law, the grounds for review by the court of rendition are: where there is procedural irregularity during the first judgment; where there is discovery of new evidence which is not known during the first judgment; and where an objection is made by a third party who has interest in the matter in relation to the judgment passed. Do you think that these requirements are also requirements to set aside a judgment in bankruptcy? I hope that your answer would be “No”. If you answered so, well done!

What do you think are the grounds on which the court can set aside the judgment in bankruptcy? In order to answer the question, you can read the provisions of Article 988 of the Commercial Code.

*Art- 988- Setting aside of the adjudication*

- (1) An adjudication shall be set aside where, between the pronouncement of the judgment and the date of the order given in respect of an application to set aside or an appeal, the bankrupt has restored his affairs by repaying his creditors or by obtaining a composition.
- (2) The effect of acts taken by persons responsible for conducting bankruptcy proceedings shall not be affected.

As per the above-mentioned Article, there are two important grounds on which the court can rely in order to set aside the judgment. The *first* is where the debtor has made repayment to the creditors and thereby settled his affairs with the creditors. Where the debtor has effected payment of the claims of each of the creditors, there is nothing the latter can claim against the former. Where there is no claim of creditors against the debtor, there is no reason why the court should continue with the bankruptcy proceedings. The judgment in bankruptcy made has to be set aside. The *second* ground is where the debtor has obtained a composition. Where the debtor obtained a composition, by which he proposed something by which he can settle his affairs with the creditors and the latter have agreed on the proposed composition, still there is no justification for the court to continue with the bankruptcy proceeding. Therefore, as different from the situation of review of judgment by the court of rendition in civil matters, the grounds for setting aside a judgment are repayment or obtaining composition.

However, you have to note that there is a time limit within which the debtor has to make repayment or obtain composition. It should be in the time between the date of pronouncement of the judgment and the date on which an order is made on the application to set aside or an appeal. After the judgment is made, the debtor may take initiative to make payment to all the creditors and thereby escape from the disadvantages of bankruptcy. In other case, he may propose a composition that is accepted by the creditors so that the affairs are to be restored. Where one of these is satisfied, it is a good ground for the court to set aside the judgment it passed.

On receipt of the application to set aside, the court has two options: to accept the application and set the judgment aside, or to reject the application and refuse to set the judgment aside. As we have seen earlier, the judgment is to be set aside where there is a situation of repayment or composition. In case, one of these conditions is fulfilled, the court can accept the application and set aside the judgment. Where the judgment is set aside, such has to be notified to the trustee, the creditor who presented the petition, and

the debtor. The notice would be given to the debtor only where he has not applied to set aside the judgment. Read the provisions of Article 985 of the Commercial Code:

*Art. 985- Judgment on application to set aside*

- (1) A judgment rejecting an application to set aside shall be notified to the person having lodged the application.
- (2) A judgment setting aside an adjudication of bankruptcy shall be notified to the trustee, the creditor having petitioned and the debtor, where the debtor has not lodged an application. The provisions of Art. 983 shall apply.

As you read from the given provision, where the application is rejected, the fact that it is rejected has to be notified only to the person who lodged the application for setting aside. There are no more obligations on the part of the court to notify to the other persons. As regards the procedure of notice, it could be made by inserting in a newspaper or an official commercial gazette.

Do you think that a person can lodge appeal against the judgment in bankruptcy? I think that your answer will be “Yes”. If you answered so, that is correct. Apart from the possibility of setting aside, it is also possible to lodge an appeal against the judgment in bankruptcy. As mentioned earlier, the application to set aside is to get the judgment reviewed by the court that has passed the judgment whereas; the appeal is to get the judgment reviewed by the next higher court to the court of rendition. Read the provisions of Article 986 of the Commercial Code:

*Art. 986- Appeal against judgment*

- (1) An appeal against a judgment in bankruptcy may be lodged within fifteen days from notification.
- (2) The appeal shall be heard summarily within three months and the judgment shall be enforceable immediately.

The ground for appeal, as it is in the other civil cases, could be dissatisfaction with the judgment by one of the parties. It could be lodged by the creditor or the debtor.

The appeal is to be lodged within a fixed period of time; otherwise it would be barred by period of limitation. If a party is not satisfied by the judgment and is intending to lodge an appeal he has to lodge it within fifteen days from the time he got notice of the judgment. As provided in the provisions of Article 983 of the Commercial Code, the judgment could be notified by taking an extract and by inserting in a newspaper or official commercial gazette. It could also be notified by posting at the main entrance of the court.

As we have discussed earlier, all judgments and orders in relation to bankruptcy shall be enforced provisionally. It is, most probably, because of the possibility of setting aside the judgment. But where an appeal is lodged and the court of appeal has passed judgment, such judgment has to be enforced immediately and permanently. As you know, in the case of civil proceedings, there is possibility for second appeal where the judgment of the lower court is reversed by the appellate court. In case where the judgment of the lower court is not varied, there is no second appeal. When we come to bankruptcy matters, there is no law to govern the situation of second appeal. Whether the court of appeal has confirmed or varied the judgment of the lower court there is no possibility for second appeal.

Another important point to be noted in relation to appeal is that the appeal has to be accomplished within a fixed short period of time. As opposed to the situation of application for setting aside, there is a time fixed within which the appeal has to be heard and judgment made. There should be a summary hearing in which the judgment is to be passed within a short period of time. By no means should the appellate hearing take more than three months. As much as possible, the court has to accomplish the hearing and judgment within three months period from the date the appeal is lodged.

Do you think that all judgments and orders of the court are subject to setting aside or appeal? If your answer is “Yes”, that is great. There are judgments against which appeal or application to set aside is not allowed. The provisions of Article 987 of the Commercial Code provide the list of matters not open to set aside or appeal. Accordingly a judgment regarding the following is not open to set aside or appeal:

- Judgments concerning the appointment or replacement of the commissioner in bankruptcy;
- Judgment concerning the appointment or removal of the trustee;
- Judgments pronouncing as to requests for discharge and as to requests for assistance to the debtor and his family;
- Judgment authorizing the sale of property and goods forming part of assets;
- Judgments by which the court decides upon any application to set aside orders made by the commissioner in bankruptcy within the scope of his powers; and
- Judgments authorizing the operation of the business.

## **SUMMARY**

In this Unit we have discussed that the court having jurisdiction over bankruptcy matter is the court of the place where the business of the debtor situate. In this relation, we have discussed the question of jurisdiction in light of the provisions of the Civil Procedure Code and the Federal Courts’ Proclamation.

We have also discussed the different grounds of judgment in bankruptcy. Accordingly the judgment could be made either because of petition made by the persons entitled, on retirement, or after death. Where the judgment is to be made on the basis of petition of one or more of the concerned parties, the court may either enter into preliminary investigation or first hearing of the parties. The judgment on retirement may take place where the debtor is cancelled from the registry due to different reasons. The cancellation could be because of cessation of trade or death of the trader in the case of physical persons and due to winding up or dissolution in the case of business organizations. The

judgment could be made if the debtor has already suspended payments before his death. Therefore, one could be declared bankrupt from his grave.

The other important point we have seen in this Unit is the effect and enforcement of the judgment in bankruptcy. As far the judgment of the court is concerned, it would not be enforced permanently, but only temporarily. This is mainly because of the possibility of appeal and setting aside the judgment. We have seen the grounds for setting aside and appeal and also the persons entitled to lodge applications for setting aside or for appeal. The application to set aside as well as the appeal has to be made within a fixed period of time; otherwise it would not be acceptable.

Still another important issue we discussed is the effects of adjudication of bankruptcy as regards the debtor. As a result of adjudication of bankruptcy, the debtor is to be exposed to some prohibitions or restrictions; for example, restriction of the freedom of movement and freedom of communication. The debtor is to be entitled for certain rights or privileges as an effect of his adjudication. The adjudication may also bring about invalidation of certain acts of the debtor that take place prior to his adjudication. Some of the rights acquired before adjudication may also be invalid as a result of adjudication of bankruptcy of the debtor.

The adjudication of bankruptcy also has several effects as regards the individual creditor or all the creditors collectively. This is also one of the issues we discussed in this Unit. As a result of the adjudication, all the creditors are to respect the principle of collective enforcement. All the unsecured creditors come together under the umbrella of the universality of creditors in bankruptcy proceeding. The universality is a legal's person enjoying rights and incurring liabilities. Moreover, where a creditor has already instituted against the debtor, as a result of adjudication of his bankruptcy, the proceeding suspends and the creditor joins his claim to the universality of creditors.

The last issue we discussed is the management of properties of the debtor. Management is to be made by the trustees with the assistance of the commissioner and the court. The

trustees are to discharge several responsibilities in order to effect management of the properties of the debtor. Of the various functions some are: to sell properties or business, to enter into compromise and arbitration, to collect debts, and to cancel or continue a lease relationship.

## **REVIEW QUESTIONS**

1. What is universality of creditors?
2. Why the universality of creditors? (What do you think is the rationale behind universalizing creditors?)
3. Imagine the provision of article 1025 of the commercial code is missing. What do you think would have been the consequences?
4. What do you think is it necessary to fix the date of suspension of payments while it is proved that there is suspension of payments?
5. Do you think that article 979 and 980 apply to commercial business organization? Why or why not?
6. Explain the effects and enforcement of Judgment.
7. Do you think that the person who has petitioned can lodge an appeal against the judgment in bankruptcy? Why or why not?
8. Does the Ethiopian bankruptcy law recognize “discharge”?
9. Do you believe “discharge” applies to bankrupt traders and bankrupt business organizations alike?
10. Do you believe there are debts for which the commercial code doesn’t approve “discharge”? Or are there there are debts that are excepted by the commercial code for not warranting “discharge”? When could a bankrupt be discharged under the provisions of the Ethiopian commercial code? Is there any relationship between the closure of bankruptcy proceedings and “discharge”?
11. Discuss the effects of adjudication of bankruptcy as regards the debtor, creditors and third party.

12. Explain the functions of the trustees in the management of properties of the debtor.
13. Do you think that the debtor loses his right of ownership over the property as a result of adjudication of bankruptcy? Why or why not?
14. Read Article 1033. Do you think that the difference of the instrument is still under negotiations i.e, it is transferring from one hand to another? Why?
15. Discuss the lights of the debtor to be restricted as a result of the adjudication of bankruptcy?

**CHAPTER THREE**  
**PERSONS RESPONSIBLE FOR CONDUCTING BANKRUPTCY**  
**PROCEEDINGS**

Dear student! as you might have recalled in our chapter two lesson, we have seen some general and specific points concerning conditions for declaration of bankruptcy, judgment of bankruptcy and enforcement of judgment. In addition, we have also seen administration of bankrupt estate and the effects of bankruptcy declaration as regards the debtor and creditor. In this chapter, an attempt will be made to discuss persons responsible for conducting bankruptcy proceeding.

**Introduction**

The bankruptcy Proceeding is a result of the combined effort of different persons. It is not a single day task to be accomplished and takes a certain period of time. There are several activities to be performed by the different persons responsible for that effect until the final property is sold and the proceeds of the sale are distributed among the various creditors. The court, the commissioner, the trustee, and the creditors' committee are the most important persons to play a dominant role in the proceeding. The first three have a kind of hierarchical relationship in that the court is on the top and the trustees at the bottom. In this chapter, we are going to discuss the different activities to be performed in the proceeding and the persons responsible for them.

The chapter is divided into four general sections. Each of the general sections has sub-sections under it. The first section deals with the commissioner as one of the persons responsible to carry out the bankruptcy proceedings. The commissioner is responsible to discharge certain duties and perform different activities in relation to the bankruptcy proceedings. The different responsibilities and activities will be discussed under this section. The second section is on the trustee. We will discuss, under this section, that the trustees are responsible for the day-to-day activities, in relation to the bankruptcy proceeding. The third section deals with the court. In this section we will discuss the

different responsibilities of the court and the activities it has to do so that the proceeding goes properly. The fourth and last section, will deal with the creditor's committee. In this section we will focus on the roles, composition, and powers of the creditors' committee in relation to the bankruptcy proceedings.

## **Objective**

At the end of this chapter, the student will be able to:

- Explain the court which has jurisdiction over a bankruptcy proceeding and its power;
- Articulate the relations among persons responsible for conducting Bankruptcy proceeding;
- Highlight election, appointment, functions, powers, remuneration, disciplinary measure, removal and liability of trustees;
- Explain the appointment and functions of creditor's committee; and
- Highlight administration and management of bankrupt estate.

### **3.1. The Court**

It is the court that has jurisdiction on the bankruptcy matter and thus declared the debtor bankrupt that can play a role in the proceeding. The court has the following powers in relation to the bankruptcy proceeding of the debtor who is declared bankrupt.

#### **3.1.1. Hearing of appeals from the orders of the commissioner**

The commissioner is empowered to make orders on matters falling within his power limits. The order to be made by the commissioner may not satisfy every party. Sometimes the orders of the commissioner may offend either the creditors or other concerned persons. There is a possibility to lodge an appeal against an order where a person is not satisfied with the orders of the commissioner. It is within the power of the court to hear

and pass judgment on the appeal. The court can hear all claims in relation to the bankruptcy, except few claims. Pursuant to Article 990 of the commercial code of Ethiopia; *unless there be claims in rem concerning immovable property which remain subject to the ordinary rules relating to jurisdiction, the court which has declared the debtor bankrupt shall have jurisdiction to hear all claims arising in the bankruptcy.*

The implication here is that irrespective of the material jurisdiction, the court can have jurisdiction over all claims relating to the bankruptcy. The value of the claim of the party is immaterial to determine whether the court has jurisdiction on a given claim. Where a claim is related to an immovable and is a claim in rem, then the jurisdiction is to be determined by the rules of the Civil Procedure law.

The last phrase of the provisions of sub-art(2) of this Article provides that, claims in rem related to immovable shall be governed by the ordinary rules of jurisdiction. This implies that jurisdiction of the court in relation to all the other claims is to be governed by special rules. In other words, all other claims are not to be subject to the ordinary rules of jurisdiction. This can also be inferred from the provisions of Articles 974 and 1157 of the commercial code. These two provisions indicate that bankruptcy matters are subject to special rules of jurisdiction because none of them is bound by ordinary rules of material jurisdiction. Both focus only on the local jurisdiction as they provide that the court having jurisdiction is the court of the place where the business is situated.

### **3.1.2. Making orders on matters which are outside the powers of the commissioner**

The commissioner's power is limited to some extent and he is not allowed to make orders on matters that fall outside his power. As the court is above all other responsible persons, matters beyond the power limits of the commissioner are to fall within the power of the court. Where there is a need to make orders on such matters, it is the court that is empowered to do so.

### **3.1.3. Supervision of the overall bankruptcy proceedings**

It is the court that has the ultimate power of supervising the overall activities in relation to the proceeding. Hierarchically, the court stands above all the persons responsible to conduct the bankruptcy proceedings. In other words, it is the court that can pass the last decision.

## **3.2 The Commissioner**

The commissioner is next to the court down in the hierarchy of persons responsible to conduct bankruptcy proceedings. The activities of the commissioner are subject to the supervision of the court. The following are the powers and responsibilities of the commissioner in bankruptcy as per the provisions of Article 991 of the Commercial Code.

### **3.2.1 To authorize the trustee to enter appearance in legal proceedings**

The trustee is the representative of the debtor and, therefore, all proceedings brought against the debtor are to be defended by the trustee. The commissioner has the power to authorize the trustee to be present in such court proceedings where there is a need to defend cases brought against the debtor. The commissioner is expected to effect the authorization in a written form.

### **3.2.2 To authorize the trustee to appoint assistant**

The activities to be carried by the trustee are multifarious. Those different activities demand different qualification, skill and knowledge. Where the activities could be discharged by the trustee because he has the required knowledge or skill, the trustee can do them by himself. It could be only in rare cases that the trustee could be all rounded person. The trustee is to be forced to look for other person's assistance where the activities require knowledge or skill different from what he has. In that case it is within

the power limits of the commissioner to authorize the trustee to appoint assistant. The trustee can determine by himself to appoint assistants in relation to certain activities of the bankruptcy proceeding. It is only where such appointment is found to be in the interest of the bankrupt estate that the trustee can take initiative to appoint assistants. Otherwise, it is one of the responsibilities of the trustee to discharge the duties by himself.

It is not merely subject to the whims and volitions of the commissioner that the trustee appoints assistants. Rather, it is only where such appointment is found to be in the interest of the bankrupt estate. For instance, assume that the available properties of the debtor are few, which could be managed by one person. The commissioner authorized the trustee to hire three persons to take care of the properties. In this case, it would not be proper because the commissioner authorize appointment of three persons even when it is not in the interest of the bankrupt estate. In general, where there is nothing serious that can hamper the bankrupt estate, it would not be proper if the commissioner authorizes the trustee to appoint assistant.

### **3.2.3 To call the creditors' committee**

The proceeding in bankruptcy is the result of combined effort of different persons. The commissioner could do his activities in cooperation and coordination with the creditors committee. The commissioner is expected to call up on the creditors' committee and consider the advice of the committee where there is a need to consult the committee. However, the commissioner could not simply call the committee as it pleases him. Rather, it should be in accordance with what is provided by the law or where the commissioner thinks that calling the committee is necessary.

### **3.2.4 To take or cause to be taken by the competent authorities all steps necessary to preserve the assets**

The overall purpose of the bankruptcy proceeding is to collect the properties of the debtor and realize them for the satisfaction of claim of the creditors. The available properties of the debtor have to be preserved and be ready for realization in order to achieve such purpose. It is within the power and responsibility of the commissioner to take or cause necessary steps to be taken since he is responsible to supervise all matters in relation to the bankrupt estate. If there is an appropriate and necessary measure to be taken by the commissioner, he could do that without looking for another body. But where the measure is some thing to be taken by another appropriate body, then the commissioner is expected to do his best to enable that body to take the steps. For instance, assume that some of the properties of the debtor are collected and put in a warehouse or a certain compound. The debtor himself made repeated attempts to take some of the properties from where they are deposited, but without success. In this case, the commissioner has the power and responsibility to cause legal measures to be taken against the debtor.

### **3.2.5 To refer to the court claims which fall within the jurisdiction of the court**

The commissioner is more attached to the day-to-day activities than the court in relation to the bankruptcy proceedings. The commissioner can come across certain matters falling within the jurisdiction of the court in the course of discharging his responsibilities. Where he finds such matters, it is the responsibility of the commissioner to refer them to the court. The court is expected to mention the fact that the claim is referred by the commissioner. It has to be noted here that it should not be a matter which can be decided by the commissioner as it falls within his power limit. The claim should be one that is beyond the power limit of the commissioner and as a result of which the court is responsible to entertain it.

### **3.2.6 To Supervise and deal with all matters concerning the bankrupt estate**

The bankrupt estate is the totality of all the available properties belonging to the debtor who is declared bankrupt. The estate is a legal entity which enjoys all the attributes of a person. The commissioner is empowered to supervise and deal with all matters related to the bankrupt estate. All matters other than those related to the bankrupt estate are not within the power limits of the commissioner, but within that of the court. The court is empowered to supervise the overall bankruptcy proceeding. Next to the court is the commissioner. The power of the commissioner is not as extensive as the court.

### **3.3 Trustees**

Trustees are persons responsible for the day-to-day activities in relation to the bankruptcy proceeding. It is not any person who could be appointed as trustee. There are certain requirements to be fulfilled so that a person could be appointed as trustee. *First*, the trustee should be resident in Ethiopia. Where he is not residing in Ethiopia, he could not discharge the responsibilities properly. In other words, administration of the assets of the debtor by proxy is not allowed. An issue possibly to be raised is whether the trustee would necessarily be an Ethiopian citizen. As far as the provision of Article 994(1) of the Commercial Code is concerned, it does not clearly provide an answer to the question. But one can simply argue that the law, as it does not expressly provide, seems to allow both citizens and non citizens so long as they are residents of Ethiopia to be trustee and can serve the purpose. *Second*, the person should be one who has good repute. It is obvious that the activities of the trustee are more related to the properties of the bankrupt and the interests of creditors and are therefore considerable responsibilities. In order to discharge those responsibilities one is required to have good reputation. He should be reliable person to deal with the properties of the debtor and interests of the creditor.

Apart from the above discussed, there are other requirements so that a person could be appointed to be trustee. As you read from the provision of Article 994(4) of the commercial code, certain persons are not allowed to be trustees. A person who is the

relative of the debtor could not be a trustee in relation to the bankruptcy of the debtor. The relationship could be either blood relationship or relationship arising from marriage. However, note that it is only to the fourth degree that the relationship is to be considered. The person can be appointed as trustee where it is beyond the fourth line. The other category of persons to be excluded is those who are deprived of their civil rights. Where a person is deprived of civil rights by the order of court of justice, it is deemed that such person is incapable to discharge obligations like trusteeship. While one is deprived of his civil rights, he could not stand surety or any kind of guarantee. Other category of person who is not allowed is that who are already declared bankrupt. The activities of the trustee demand reputation and reliability because they are directly or indirectly related to the administration of the estate. In order to administer the properties of the debtor, the trustee should not be one who is already declared bankrupt. A person who is declared bankrupt is not a proper person to discharge obligations related to money and properties of the debtor; the trustee should not be one who is already declared bankrupt. Last, but not least, a creditor of the debtor could not be appointed as trustee. There is a logical justification to his. The trustee is going to be the representative of the universality of the creditors. While he is to represent the creditors collectively, there would be conflict of interest between that of the trustee and the creditors. It would, therefore, be not proper to appoint a creditor to the position of trustee so that he would represent the creditors collectively. Within the collective interest to the creditors, there is a share of the creditor who is appointed to be a trustee.

The Law under Article 994(2) provides that to the maximum three trustees can be appointed. Where the duty could be discharged by one or two trustees, it is not necessary that there should be three trustees. Only one or two could be appointed depending on the size of the estate and the duties thereof.

Where there are several trustees appointed to discharge the duties, their liability is joint liability. In other words, all trustees shall be responsible for the act of one of them or joint acts. Normally, they are expected to do the duties jointly and are to be jointly liable for any liability to arise from such act or forbearance. But where the commissioner has

authorized one or more of them to act individually, such trustees shall be liable severally (individually). For instance, assume that three trustees (Alemu, Mersha, and Tilaye) were appointed to do the activities in relation to the bankruptcy of a certain debtor. Of these three trustees, the commissioner authorized Alemu and Tilaye to discharge certain activities jointly. In this case, it is only Alemu and Tilaye who shall be responsible for acts or forbearances in relation to the activities to which they are authorized. In other words, not all the three trustees are jointly liable. Ato Mersha will be relieved from such liabilities.

As provided by the provisions of Article 994(5), the trustee should not acquire the properties of the debtor. As mentioned earlier, the trustee is an agent of the debtor. One of the important principles of agency is that there should be no conflict between the interests of the principal and the agent. As the trustee represents the debtor, as much as possible, there should be no conflict between the interests of the two. One way by which conflict could be avoided is by prohibiting the trustee to acquire the properties of the debtor. Where the properties of the debtor are to be sold either by auction or otherwise, the trustee is deprived of the right to participate in the bid to such properties. If he is participate allowed to participate, one can simply guess what the trustee could do. Most probably, the trustee would do acts that can pave the way to protect his interest at the expense of others' interest.

### **3.3.1 Powers and duties of the trustees**

The trustee is empowered to administer the properties of the debtor, represent the creditors collectively, and to discharge the functions in person. Now let us briefly discuss these powers and responsibilities of the trustee.

### **3.3.2. Discharge of duties with all care**

Normally, on matters of other persons, a person is not as careful as he is to his matters. The trustees are dealing with matters of the bankrupt person for the benefit of the

creditors. In discharging their functions, what is expected of the trustee is to be like bonus pater families, i.e., to employ utmost good faith. The trustees are to be considered as public officials in their exercise of the functions. They are expected to employ care in relation to the functions. In some cases, the trustees are expected to show that they have employed the necessary care.

### **3.3.3. Deposit funds**

The trustee represents the debtor. The trustee is empowered to collect funds payable to the debtor. All payments due and payable to the debtor are to be collected by the trustee. The trustee is expected to deposit such fund in a bank account in the name of the bankrupt estate after collecting such funds. Actually, the fund is to be deposited after the legal costs and administrative expenses, as ordered by the commissioner, are deducted. Once the fund is deposited, it would not be withdrawn unless the commission makes orders to that effect. In case the trustee has failed to deposit the funds he collected promptly in a bank account in the name of the bankrupt estate, he shall be removed from his position without any precondition. The fact that he is removed from his position could not bar other civil or criminal actions to be taken against him. (Read Article 996 of the Commercial Code).

### **3.3.4 Do functions in Person**

The trustee is appointed after certain requirements are fulfilled. The personal qualities of the trustee are very much considerable. The trustee's experience and qualification is considerable apart from his behavior. It would not be proper if the trustee transfers the functions to be done by another person where he is appointed by taking into account such considerations. As a consequence, the trustee is not expected to assign his functions to another person. But in some cases, he may delegate the functions to another person. The trustee can delegate functions only where the commissioner has approved such delegation in respect of isolated transactions. Therefore, the trustee can delegate his functions only in respect of certain isolated transactions.

### **3.3.5 Represent the universality of creditors**

One of the principles of bankruptcy is the collective enforcement of rights by the creditors. Where the creditors have proved their respective claim against the debtor, they form the universality of creditors, which is a distinct entity. The universality is a fictitious person that is created by law. Being fictitious, it is necessarily to be represented by physical persons. As per the law, it is the trustee who can represent the universality of creditors. Therefore, where there is a right, the creditors collectively claim against a third party, they are to be represented by the trustee.

The trustee can not represent one or more of the creditors in their relation one with the other. He can represent only in their relation to third parties. In such relation, the creditor is to stand in person. For instance, assume that Abay, Getu, Molla, and Negash are creditors of the debtor, who is declared bankrupt. Ato Mesfin was holding a property belonging to the debtor. After coming to know that the debtor is declared bankrupt, Ato Mesfin refused to bring the property to the estate of the bankrupt. As a result, the creditors wanted to bring action against. Ato Mesfin and thereby protect their interest. In this case, the trustee has to represent the creditors and bring the action on their behalf. But, if we assume that Ato Abay has a claim against Molla and if the former wanted to bring action against the latter, the trustee has no power to represent Abay.

### **3.3.6 Administer the bankrupt estate**

Administration is more general in that it covers different activities the trustee is expected to do falling within the concept of administration. It requires day-to-day follow up on the part of the trustee. He is to collect all the properties of the debtor, take all necessary steps for the up keep of the properties, enter into different transactions such as compromise, and negotiation. The trustee is to perform administrative activities under the supervision of the commissioner.

### **3.3.7. Remuneration of trustees**

As the trustee is expected to discharge obligations, he is entitled to a right. The remuneration could include costs he incurred or fees. Such remuneration is to be fixed by the commissioner. Where there is dissatisfaction by the remuneration fixed by the commissioner, an objection could be made against such order. The objection could come either from the debtor himself or a creditor. Basically, the objection could come demanding reduction of the remuneration where it is though unreasonably high. Such demand could normally come from the creditors or the debtor. That is why the application could come from such persons. The objection has to be made within eight days from the date on which the order fixing the remuneration is made.

It is not any time that the trustee can get payment of the fixed remuneration. It is only on presentment of the last report in relation to the bankruptcy proceeding. But exceptionally, where there is justifiable ground, the trustee could be entitled to advance payment with the consent of the commissioner. Even if the report is not yet submitted, a trustee may get payment of the whole or part of the remuneration fixed before the closure of the bankruptcy proceeding. In other words, the remuneration of the trustee is not like salary that is to be paid within fixed intervals. It is only to the fees and costs that the trustee is entitled. Where another payment than the remuneration fixed by the commissioner is effected, the trustee should return such payment. Besides that, he should be exposed to the appropriate civil and/or criminal sanction for his acts. Article 1001 of the Commercial Code deal with remuneration of trustees.

### **3.3.8 Controlling the activities of trustees**

In the exercise of the powers and responsibilities entrusted to him, the trustee may make orders and do acts but concerned parties, including the bankrupt person, may be dissatisfied with such order or act. Any person who is dissatisfied can object the orders and acts of the trustee. The bankrupt or any interested person who is dissatisfied by the acts of the trustee can present his objection to the commissioner. After receiving such

objection, the commissioner is expected to make decision on the objection promptly. It is a kind of summary procedure in that the commissioner has to decide within three days period. However, you have to note here that the objection should be raised only in relation to orders or acts of the trustee regarding the bankrupt estate. Any dissatisfaction on the acts or orders of the trustee beyond the bankrupt estate is not the subject of such objection and it is not within the power of the commissioner to decide on such objection. For instance, the trustee has done a certain act which dissatisfied one of the creditors. The act may be done as regards the personal transaction between the creditor and the trustee, which has no relation to the bankrupt estate. In this case, the creditor cannot present his objection to the commissioner and even if he presents, the commissioner should not decide on it.

Normally, the trustee is to be appointed for the whole period within which the bankruptcy proceeding pends. But where he does acts that are unacceptable and unlawful, the trustee could be removed even if the bankruptcy proceeding is not yet accomplished. The move for the removal could be initiated either by the debtor, the creditors' committee or by the commissioner himself. The power to decide on the removal of the trustee lies on the court. The commissioner has no power to remove the trustee. Here it seems logical that while he has not appointed the trustee the commissioner should not remove him from his position. what the commissioner can do is just to move the court to remove either based on the application of the debtor, the creditors' committee or on his own motion. An application has to be dealt within a short period of time. It has to be dealt with within five days from the time of receipt of the application. Where there is failure on the part of the commissioner, the explanations of the trustee and the opinion of the public prosecutor. It is not full trial to take place, but a kind of hearing so that there will be fair decision as there should be an opportunity for one to be heard before decision is passed. The court has to pass decision in open court.

It is not only removal that could take place. The trustee could be replaced by another one. Where there is sufficient justification to that effect, the trustee could be replaced by

another trustee. In other case, where a need arises, the commissioner can move the court to appoint additional trustee/s.

The mere fact that the trustee is removed from his position of trusteeship because of justifiable ground does not relieve him from being questioned for his wrong doings. The trustee is expected to discharge his function with utmost good faith and in accordance with rules of the law. Where he has acted otherwise, a claim could be raised against him. In case there is a claim to be raised against the trustee who is removed before the closure of the bankruptcy proceeding, such claim can be instituted by the trustee who replaced him. In fact, there should be prior consent of the commissioner to that effect.

### **3.4. The Creditors' Committee**

No person could be considered as creditor of the debtor where he has not properly proved his claim before the appropriate body. The creditors' committee could be a provisional one or permanent. After the claim is proved, a list of the creditors is to be produced and the commissioner can appoint three or five of them to form the creditors' committee. The commissioner can form a provisional creditors' committee where he thinks it appropriate. Such a committee is to be formed before the list of the creditors is produced. For the production of list of the creditors, it waits for the time of proof of debt. Such committee is a permanent creditors' committee. The permanent committee has to be appointed within ten days from the time of deposit of the list of creditors with the registrar of the court. The commissioner shall appoint a chairman from among the members of the committee. A person who is related to the debtor, or a person who is declared bankrupt, is not appropriate to be a member of the creditors' committee.

The members of the creditors' committee can be replaced and removed by other persons. Once he has appointed the commissioner cannot replace a member by another person unless a member himself demands that. Where there is sufficient ground, the members can be replaced by another person on their request. Where the request comes from a member it is the commissioner who appoints the one to replace. However, as regards

removal, it is within the power of the court to remove a member of the committee. The court can remove where the commissioner presents proposal to that effect.

### **3.4.1 The function of the creditor committee**

Article 1003 of the commercial code of Ethiopia deals with the functions of creditors committees. Pursuant to this article, the committee is empowered to provide advice where such is found to be appropriate. There could be a law providing for the importance of the advice of the committee or an advice could be requested by the trustee. In such cases, a meeting of the committee is to be called, at which the advice is to be produced. In other words, it would not be proper if the members of the committee requested advice and produced their respective advice in writing. There should be meeting and the advice will be the one agreed by the majority of the members, since the decision of the committee is to be passed by majority vote. Of all matters, the committee shall have special regard to three important aspects of the bankruptcy proceeding. It shall have regard to the verification of the accounts and the statement of affairs prepared by the debtor, and to the supervision of the acts of the trustees. The trader, normally, is expected to keep accounts in relation to his trade. On declaration of bankruptcy, the books of the debtor are to be closed. For the closure, the debtor himself may present the accounts. The creditors' committee is to pay attention before it approves the account prepared by the debtor. As regards all other matters, the debtor may present details. The statement of affairs of the debtor has to be carefully verified by the committee before it is accepted and verified. Moreover, the committee is empowered to supervise the acts of the trustees. The day-to-day activity of the trustees is related to the administration of the bankrupt estate. Moreover, he could represent the universality of creditors. The committee has the power to supervise the acts of the trustee so that to check it he is doing acts within the bounds of his power.

To enable the committee to carry out the supervision, the law gives wide power to it. The committee may at any time require information on the state of the bankruptcy proceedings and on the position of the receipts and payments. In exercise of such power,

the committee can require any information related to the bankrupts proceeding from the trustee and if it is found necessary to provide advice, it can do so. The trustees can request the committee to provide consultancy as regards all legal proceedings. In all legal proceedings against the debtor, it is the trustee who is to represent. Even where a proceeding is to be initiated by the debtor, it is the trustees who can represent the debtor. Moreover, the trustees are representatives of the bankrupt estate and the universality of creditors. Where there is a legal proceeding, the trustees can get the committees consultation.

The committee collectively or the individual members are not entitled to any remuneration. They are expected to discharge the aforementioned functions for free. The only payment to which they are entitled would be refund of expenses they made in relation to the bankruptcy proceeding. Even in that case, it is only where the commissioner has approved such expense in writing that refund is to be allowed. In other words, all requests by the members to get refunded would not be treated unless the commissioner accepts and approves that as an expense made in relation to the bankruptcy proceeding.

## **CHAPTER SUMMARY**

Chapter II of Title II (Arts. 989-1003) contains a detailed description of the persons responsible for conducting bankruptcy proceedings. Even a brief summary of these provisions would be useless. They govern the very administration of bankruptcy and raise numerous questions which must be resolved by the codification commission. The proposed texts presuppose a strong judicial system and also the existence of body of administrators able to carry out the complex and delicate operations of bankruptcy. On this point, we advise you to refer Article 996 which requires the trustee to deposit the funds which he receives. In our opinion, this is an essential requirement.

Section four of this chapter deals with a new institution: the creditors' committee which is designed to give creditors a representative body which is more flexible and less difficult to operate than a meeting of the creditors as a whole. The experience of the Ethiopian members of the codification commission is important in assessing this institution's chances of success.

## REVIEW QUESTIONS

1. Explain in detail the law and the practice of election, appointment, functions, powers, remuneration, discipline, removal and liability of trustees.
2. Which court has jurisdiction over a bankruptcy proceeding? Explain it in light of the civil procedure code and the present federal structure of the country.
3. Describe matters which are within the jurisdiction of the court, but outside the powers of the commissioner.
4. Enumerate the relations among persons responsible for conducting Bankruptcy proceeding – their interactions intra –and with others.
5. Discuss the powers and functions of the commissioner.
6. Explain how the court appoints additional trustees and replace existing trustees, and the ground to do so, if any
7. Discuss how the trustee administer and manage the bankruptcy estate.
8. Proof the following assertion: *“A trustee is an agent of the creditors in strict sense of the term”*
9. Explain in detail the appointment and function of creditors' committee. Is there any criterion the trustee should follow to select and appoint a creditor to be a member of a committee.
10. Explain how the commissioner is replace with other commissioner, and the ground to remove the commissioner form his office, if any.

## **CHAPTER FOUR**

### **MEASURES IN RELATION TO THE ASSETS OF THE DEBTOR**

#### **Introduction**

After the adjudication of bankruptcy of the debtor, there are certain measures to be taken in relation to the properties of the debtor. As we discussed earlier, the overall purpose of the bankruptcy proceeding is to collect the properties of the debtor, effect sale of such properties, and distribute the proceeds of sale to the creditors. In order to collect the assets of the debtor, two types of measures are to be taken by the persons responsible to conduct the bankruptcy proceeding and other competent authorities. The two types of measure are: conservatory measures and provisional measures. In this Unit we are going to discuss each of these measures.

The Unit is divided into two general sections, of which the second having sub-sections. The first section is on conservatory measures. In this section, we will focus on the measures to be taken by the different persons responsible with the view of preserving the properties of the bankrupt person. There are several steps to be followed in the measure, which will be discussed in detail in this section. The second section will deal with the provisional measures. These are measures to be taken by the different responsible bodies after the preservatory measures. In this section, we will discuss in detail about affixing of seals and the removal of seals, and inventory of the properties of the bankrupt person.

#### **Objectives**

At the end of this Unit, you should be able to:

- enumerate the preservatory measures;
- identify the responsible persons to take the conservatory measures;
- list the steps in conservatory measures;
- enumerate the provisional measures;
- discuss the measures of affixing seals and making inventory, and
- dispose practical cases in relation to measures.

#### 4.1. Conservatory Measures

Conservatory measures, as the name itself indicates, are a kind of safety or preventive measures. They are measures to be taken in order to preserve the properties and other rights of the debtor so that they could be available for satisfaction of claim of the creditors. The conservatory measures are to be taken by the trustees with the assistance of the debtor and the public prosecutor. Mainly, it is the responsibility of the trustees. In their effort to preserve the properties and other rights of the debtor, the trustees are expected to do the following acts, namely, to close the books of the debtor, to preserve the rights of the debtor, and to effect registration of mortgage on the immovable of the debtor and the business of the debtor. Now let us discuss each of these measures.

The *first measure* in the process of the conservatory measures is closing the books of the debtor. On adjudication of bankruptcy of the debtor, his business has to stop where it is unless the court has ordered for the continuity of the business. It is worthy of note, that it is always assumed that the trader keeps the necessary books of account related to his business.

The closure of books of the debtor shall be in the presence of the debtor. In order to enable the debtor's presence, the trustees are duty bound to summon the debtor. Where the debtor has failed to be present at the time of writing up and closing the book, again another summons is to be made to him. In the second case, the summons shall be made by registered letter. The time within which he is expected to be present is forty-eight hours. In case the books to be closed are in his hands, the debtor is to be ordered to come with those books on the day of the writing up and closing of the books.

Do you think that the debtor should always be present in person? I hope your answer is "No". If you answered so, that is right. In principle the debtor is expected to be present in person at the time and place of writing up and closing the books. But in exceptional case, the debtor could be represented by an attorney. The exceptional cases in which the debtor could be represented by an attorney is where there is sufficient cause to justify that he

could not be present in person. The standard for the justification is a subjective standard. It depends on whether the commissioner is satisfied with the reasons or not. Where the commissioner is satisfied that there is substantial reason to prevent the personal presence of the debtor, then an attorney can represent him. But where the commissioner is not satisfied with the reasons that prevented the personal presence of the debtor, it won't be allowed to be represented by attorney. Even if the reasons are to satisfy a reasonable person, the commissioner may not be satisfied with them. In that case, as the standard is subjective, the commissioner can insist that the reason is not justifiable. But where the debtor is not satisfied with the decision of the commissioner, he can lodge an appeal to the court where his reasons could be satisfactory in the eyes of a reasonable person.

We have discussed above that the debtor could be present either in person or through attorney, where there are acceptable reasons to prevent his personal presence. Sometimes, the debtor may not be present either in person or through attorney. What do you think will happen in case the debtor fails to be present in person or through attorney? To answer this question, read sub-art. (4) of the provisions of the following Article from the Commercial Code:

*Art. 1004- Closing of debtor's books*

- (1) The trustees shall summon the debtor to be present at the writing up and closing of the books, the provisions of Art. 1011 having been complied with, where necessary.
- (2) Where the debtor does not appear, he shall be summoned by registered letter to appear within forty-eight hours and to produce his books if they are in his possession.
- (3) He may appear by his attorney if he satisfies the commissioner that there are substantial reasons preventing his personal appearance.
- (4) Where the debtor fails to appear, either in person or by his attorney, or where he absconds, the commissioner shall inform the public prosecutor who shall take the necessary steps to secure his attendance.

As you read, where the debtor fails to be present either in person or through attorney, the public prosecutor can take all the necessary steps to secure attendance of the debtor. It is on the basis of the information of the commissioner that the public prosecutor can take the necessary steps. Not only in case where the debtor has failed, but also in cases where the debtor has absconded that the public prosecutor can take all necessary steps. The implication here is that the books of the debtor could not be written up and closed in his absence. There could be different justifications for why the law insists on the presence of the debtor. It could be because the presence of the debtor can facilitate and simplify the closing of books. In addition to that, if the debtor is present in person or through his representative it would minimize or avoid subsequent disputes related to the books of the debtor. Whatever the case may be, except for the exceptions recognized by the law, books are to be closed in his presence.

The *second* conservatory measures is to preserve the rights of the debtor. What do you understand by preserving the rights of the debtor? Did you try to answer? That is great. There might be instances where the debtor himself is a creditor of another person. Where he is declared bankrupt before he collects and enjoys such rights, the trustees are to take measures to preserve such rights so that they will be available for satisfaction of claims of the creditors. Then the question is how the trustees can preserve the rights of the debtor? Now read the provisions of Article 1005 of the Commercial Code:

*Art. 1005- Preserving debtor's rights*

- (1) The trustees on assuming office shall take all steps to preserve the rights of the debtor in relation to his own debtors.
- (2) They shall enforce registration of mortgages where registration has not been enforced by the debtor. Registration shall be made in the name of the bankrupt estate by the trustees on proof of their status.

What you can obviously understand from the above-given provision is that the trustee can take all steps to preserve the rights of the debtor. This means that where there is a need, the trustee can enter into different transactions with the view to preserve the rights of the

debtor. As a consequence, he can enter into negotiations, mediations or compromises. Where a need arises, he may conclude contracts so that he could preserve the rights of the debtor. For instance, assume that Ato Debella is the debtor of W/ro Kassech, who is declared bankrupt. The former is in possession of a property belonging to both of them. It was not clearly settled as to what is the share of each of them, before declaration of bankruptcy of Kassech. Ato Debella came to know that W/ro Kassech is declared bankrupt and lost the right to administer and deal with her properties. With the view of taking advantage of the situation, Debella claims that the property totally belongs to him. As there is no evidence to show the share of W/ro Kassech, the trustee can enter into negotiation and thereby preserve the rights of the debtor.

Another way by which the trustee can preserve the rights of the debtor is through registration of mortgage on immovable properties. The debtor might have concluded a contract of mortgage so that he gets security for the performance of obligations by his creditor. In other cases, he might have got the right of mortgagee due to operation of the law or court judgment. Normally, the mortgage has to be registered so that it could have effect. Where the debtor has got the mortgage registered before declaration of his bankruptcy, the mortgage is to be transferred to the bankrupt estate on adjudication of bankruptcy. But sometimes, the debtor may fail to get the mortgage registered. Where there is such a situation, the trustees are responsible to effect registration of the mortgage. Who do you think is the mortgagor and the mortgagee? We are discussing preserving rights of the debtor which his debtors owe him. It is, therefore, obvious that the mortgagor is the debtor to whom the bankrupt person is a creditor. The mortgagee is the bankrupt estate and not the debtor himself. For example, assume that Ato Mulu is declared bankrupt. W/ro Kassech and Ato Bedilu are the creditors of Ato Mulu. Ato Mulu (the debtor) had a building in the place of his business. No encumbrance was registered on such building in favor of the creditors or another third party. With the view of preserving the rights of the debtor, the trustee should effect registration of mortgage of the building in favor of the bankrupt estate. As far as Ato Mulu is concerned, he is no more capable to administer his properties and the business. It is the trustees who are responsible to administer the building and other properties of the debtor. Therefore, it is

the bankrupt estate who is the mortgagee of the building and the mortgagor is the debtor, who is represented by the trustees. For that matter it is also the trustees who represent the bankrupt estate.

The *third* of the conservatory measures is to effect registration of mortgage of immovable properties of the debtor. In this case, the immovable properties of the debtor are to be mortgaged. Therefore, it is the debtor who is the mortgagor. Who do you think is the mortgagee? Still in this case, it is the bankrupt estate that becomes the mortgagee. The trustees are to effect registration of mortgage in the name of the bankrupt estate.

Which immovable properties do you think are to be the subject of registration of mortgage? The answer is current as well as future immovables. Did you answer so? If your answer is so, that is great. As per the provisions of Article 1006(1) of the Commercial Code, both the immovable in possession of the debtor on the date of effecting registration and those to come to his possession at later date are to be the subjects of registration of mortgage. For instance, assume that on the day of declaration of bankruptcy the debtor had only two houses. The trustees have effected registration of mortgage of these houses in the name of the bankrupt estate. A month later, the debtor acquired a third house from his previously entered transaction. In this case, the house which he acquired after the date of registration of mortgage is also to be made the subject of mortgage in the name of the bankrupt estate.

There are two exceptions to the registration of mortgage of immovable of the debtor. *First*, where the immovable property is acquired after payment of the last dividend in composition, it would not be made the subject of mortgage in the name of the bankrupt estate. Do you know what composition is? It is an alternative to the bankruptcy proceeding by which the debtor is to propose a mechanism to settle his affairs with the creditors. We will have detailed discussion on composition in the subsequent unit. Where the debtor has proposed a composition and has complied with the commitment, the relationship between him and the creditors is thereby settled. For example, assume that Ato Mulatu is the debtor who is declared bankrupt. After the bankruptcy proceeding is

started, he proposed a composition and the creditors voted in favor of the composition. According to the proposed composition, he made payment of the last dividend to all the creditors who have a claim against him. After such payment, Ato Mulatu acquired an immovable. In such case, the immovable acquired subsequently shall not be mortgaged in the name of the bankrupt estate. Ato Mulatu has regained the rights he lost as a result of declaration of bankruptcy. As he can administer and deal with his properties, it would not be proper to register the mortgage in the name of the bankrupt estate.

The *second* exception is where the immovable is acquired after closure of the winding up procedure. The winding up process implies that all the properties of the debtor are collected and realized; the proceeds of such sale are distributed among the creditors on proportional basis. The overall purpose of bankruptcy proceeding is to satisfy the claim of creditors from the proceeds of the sale of properties of the debtor. Where the winding up process has come to an end, there is no reason why the bankruptcy process continues because it has already come to an end. Therefore, an immovable acquired after closure of the winding up procedure shall not be mortgaged in the name of the bankrupt estate.

The *fourth* conservatory measures to be taken by the trustee is registering mortgage on the business of the debtor. Do you remember what constitutes business? I am sure that you answered “Yes”. As you can recall from your study of law of business organizations, business is a property. It constitutes both corporeal and incorporeal properties. The trade mark, patents, copyrights, and the corporeal rights, namely the movable and immovable property form business.

Where a trader is declared bankrupt, just by operation of the law, the creditors of the same trader shall have the right of mortgage over the business of the debtor. It is one of the situations of legal mortgage. In such cases, the trustees are responsible to effect registration of mortgage of the business or businesses of the debtor. Note here that the mortgagor is the debtor, through the trustees, and the mortgagees are the creditors.

## **4.2. Provisional Measures**

The provisional measures are measures to be taken after the conservatory measures. There are two important provisional measures, namely, affixing seal, and making inventory. Now let us discuss each of these measures in the following paragraphs.

### **i) Affixing Seal**

Affixing a seal is a measure to keep the properties of the debtor untouched until the time of making inventory and the trustee takes control of them. A seal could be ordered to be affixed either before declaration of bankruptcy or on the date of declaration of bankruptcy of the debtor. For the order of affixing a seal before the date of declaration of bankruptcy, there are two important grounds. Can you guess the grounds for such order? I hope you have enumerated some which you think can be grounds for order of affixing seal before declaration. If that is so, it is great. The two grounds are: where there is fear of misappropriation of the whole or part of the properties of the debtor, and where the debtor has absconded.

Even if the debtor is not yet declared bankrupt, either due to frustration or bad faith, he may unusually misappropriate his assets. If he keeps the assets, he thinks that he would not get benefit out of it because the assets are to be used for the satisfaction of claim of the creditors. Where the debtor improperly uses his properties, i.e., in a way which is unreasonable in the eyes of a reasonable person, any of the creditors can apply and a seal could be affixed to the properties of the debtor. For example, assume that Ato Tesfaye is a trader who is involved in one of the activities enumerated under Article 5 of the Commercial Code. He is indebted to several creditors. His business started to fall down from time to time since the last two-month period. Tesfaye came to know that the creditors are thinking of declaration of his bankruptcy. With the view of evading the bankruptcy proceeding, Tesfaye started to misuse his assets and he became unusually careless in the management of his assets. In this case, the creditors can apply and get order for the affixing of a seal on the assets.

While the debtor is not yet declared bankrupt, who do you think is to order the affixing of a seal on the assets of the debtor? The time before declaration of bankruptcy may include the time after presentation of petition but before declaration, or the time when no petition is presented. Particularly, where no move is made to present petition, nothing is known to the court. Where the debtor is found misappropriating the whole or part of his asset, who is to order for the seal to be affixed? As far as the law is concerned, it is competent authorities who can order for the seal to be affixed. As to what constitutes competent authority, it is not expressly or impliedly enumerated. In other words, it is left for the discretion of the court to decide which one is competent and which is not. In some cases, it could be the police or the finance office and in other cases it could be the kebele administration or the court.

When can you say that the debtor has absconded? The mere fact the debtor is not around the area of his business or area of residence does not amount to absconding. Because of different reasons, the debtor may temporarily leave his residential area or the place of his business by assigning another person to carry out the business. The situation of absconding could exist where the debtor has left the area of his business without appointing an agent to take care of his business. Where the debtor has absconded, even if he is not yet declared bankrupt, the competent authorities can order a seal to be affixed to his properties.

Can the competent authorities affix a seal without receiving application? I hope you answered “Yes”. If your answer is so, you are correct. The competent authorities can take initiative to affix a seal to the assets of the debtor where the debtor has either misappropriated the whole or part of his assets or he has absconded. It is not, in fact, only by their motion that the competent authorities can affix a seal to the properties of the debtor. Where one or more of the creditors makes (s) application indicating that the debtor has misappropriated or absconded, the competent authorities can affix a seal to the assets of the debtor.

On declaration of bankruptcy, the court can order a seal to be affixed to the properties of the debtor. As we have discussed earlier, the court comes to the judgment of bankruptcy after investigation of the debtor's affairs or after hearing him and ascertaining that there is suspension of payments. Where the debtor has suspended payments and declared bankrupt, since the properties have to be kept for the satisfaction of claims of the creditors, the court is to order a seal to be affixed to such properties.

Do you think that all the properties of the debtor are subject to affixing of a seal? I hope your answer will be "No". If it is so, that is great. There are properties to which a seal could be affixed so that they can be kept untouched until inventory is made. Read the provisions of Article 1009(1) of the Commercial Code.

*Art. 1009- Affixing of seals*

- (1) The court may when declaring the debtor bankrupt order that seals be affixed to all stores, pay counters, tills, bill-cases, books, documents, papers, furniture and chattels belonging to the debtor.
- (2) Where the debtor has absconded or where there has been misappropriation of the whole or part of the debtor's assets, the competent authorities of their own motion or on an application made by a creditor may, before adjudication, affix seals to the property specified in sub-art.(1).

As you read, the seal may be affixed on all stores, pay counters, tills, bill-cases, books, documents, papers, furniture and chattels belonging to the debtor. Especially the last phrase "furniture and chattels belonging to the debtor" indicates that all properties belonging to the debtor are subject to affixing a seal. However, it has to be noted that it is not all the properties of the debtor to be made the subjects of affixing a seal. There are properties to which a seal could not be affixed, and even if it affixed it should be removed. There are three categories of assets to which seal is not to be affixed. Read Article 1010 of the Commercial Code.

*Art. 1010- Property not subject to affixing of seal*

(2) The commissioner may, on the application of the trustees, dispense them with affixing, or authorize them to remove seals on the property specified hereinafter:

- (a) such movable property and chattels needed by the debtor and his family as have been set out in a list submitted to the commissioner;
- (b) perishable goods;
- (c) property necessary for the continued operation of the business or undertaking, where such continued operation has been authorized.

(2) All property specified in sub-art. (1) shall be listed and valued by the trustees, in the presence of the competent authorities who shall sign the list.

The *first* category of properties to which a seal could not be affixed or even if already affixed to be removed are those necessary for the subsistence of the debtor and his family members. This could include several things like the clothing, the bedding, and other properties necessary for the life of the debtor and his family. As a result of the declaration of bankruptcy, the debtor and his family members should not be a burden to the community. As there is property available for the life of them, it would not be proper to let them become burden. If they are denied a means of subsistence out of the assets of the debtor, they would be either beggar or thief. The debtor shall not be denied of the basic necessities; the denial of which may threaten his life and the lives of those depending on him. If not, the bankruptcy proceeding is adding unwanted problems to the community. Therefore, it is proper not to affix a seal or to remove it, if it has been affixed, to those necessary for the subsistence of the debtor and his family.

The *second* category of properties is those which are perishable. You know what perishable goods are? These are goods which get spoiled or become out of use within a short period of time. You can think of fruits or other consumables that get spoiled or

rotten shortly. Where there are such goods of the debtor, a seal shall not be affixed. Even if it has been already affixed, the seal of such goods has to be removed promptly. Where such goods remain under seal they would get spoiled or rotten shortly. Neither the debtor nor the creditors get advantage from affixing a seal to such goods. Therefore, it is logical that such goods should not be made the subjects of affixing a seal.

The *third* category of assets not to be sealed are those properties necessary for the continuity of the business. On declaration of bankruptcy, the court may order for the continuity of the business of the debtor. There may be a number of reasons why the court orders for the continuity of business while the debtor is declared bankrupt. One of such reasons could be protecting public interest. For example, where the business of the trader who is declared bankrupt was supplying basic items for the community and if there is no other trader to fill the gap after the closure of the debtor's business, the court may order the continuity of the business for a certain fixed period of time. Whatever the reason may be, where the court has ordered the continuity of the business, the properties necessary for such continuity shall not be made the subject of affixing a seal. The type of property to be necessary for the continuity of the business depends on the type of business. For instance, where the business is one providing transport service, cars can form the properties necessary for the continued operation of the business.

After a seal is affixed on the assets of the debtor, how long the properties remain under seal? The provisions of Article 1013 of the Commercial Code provide an answer to this question.

*Art. 1013- Removal of seals*

Within five days of the affixing of seals, the trustees shall ask for the removal of the seals in order to prepare an inventory of the debtor's property.

As you read, the seal has to remain to the maximum of only five days. Starting from the day on which the seal is affixed, the trustees are responsible to ask for the removal of the

seal from the properties of the debtor. Note here that to decide whether the seal has to be removed or not is not within the power of the trustee. Though the trustee is empowered to administer the assets of the debtor, he is not empowered to decide a seal to be affixed or removed from the properties of the debtor.

After the seals are removed, the next step is to hand over the different books and documents to the trustee for preparation of inventory. The books and documents are to be handed over to the trustees by competent authorities. The authorities are responsible to hand over the books and documents after closing them. They are also expected to make a report on the state of books and documents. Where there are short term bills or bills to be presented for acceptance, the competent authorities can remove the seal and handover such bills to the trustees. You know what bills are? Bills, as you can remember from your study of negotiable instruments, are documents entitling the holder for the payment of a certain sum of money. As the bills are negotiable instruments representing money, the trustees are to claim payment on them. The competent authorities are to list the short term bills or bills acceptable. A report on such bills is also required to be made by the competent authorities to the commissioner (Read Article 1011 of the Commercial Code).

## **ii) Inventory**

After the seals are removed from the properties of the debtor, the next step or measure is to make inventory of the properties of the debtor before they are handed over to the trustee. In the process of making inventory, first of all a balance sheet has to be prepared and deposited with the registrar of the court. Where it is the debtor himself who applied and petitioned for the declaration of bankruptcy, he is expected to prepare and deposit different documents enumerated under Article 973 of the Commercial Code. The said Article provides that the debtor, who gives notice of suspension of payments, is required to annex to the notice the following documents: the balance sheet of the firm, the profit and loss account, and a list of commercial credits and debts, with the names and address of the creditors and debtors.

Where the petition for the declaration of bankruptcy is made by another person than the debtor, in some cases, the debtor himself may prepare and deposit the balance sheet with the registrar of the court. In such cases, the inventory is to be made based on the balance sheet prepared. But where there is no balance sheet prepared and deposited with the registrar of the court, the trustees are responsible to prepare and deposit within a short period of time. In order to prepare the balance sheet, the trustees can collect information from the books, papers and documents of the debtor. Besides the books and documents, the trustees can rely on other information that comes to their knowledge in the course of discharging their functions.

After preparation of the balance sheet, the inventory is to take place after summoning the debtor. The debtor has to be summoned by registered letter requiring an acknowledgment. Here one can question whether it is the intention of the legislature not to carry out the inventory without the debtor's presence. In other words, should it be mandatory that the debtor should be present at the time and place of inventory in person or through an agent? Read the provisions of Article 1015 of the Civil Code.

*Art. 1015- Inventory of debtor's property*

- (1) An inventory of the debtor's property shall be prepared, the debtor having been summoned by registered letter requiring an acknowledgment.
- (2) All property of the debtor under Art. 1010(1) shall be verified.
- (3) The inventory shall be prepared in two originals, one being deposited in the registry of the court and the other one being retained by the trustees.
- (4) The trustees may, with the consent of the commissioner, employ suitable persons in preparing the inventory and valuation of the debtor's property.

As you read from the above-cited Article, the debtor is to be summoned to be present in the inventory of his property. But there is nothing to imply that it is mandatory that he

should be present either in person or through an agent. It seems that there would be no wrong if the inventory takes place in the absence of the debtor. As we have discussed earlier, the books of the debtor would not be closed in the absence of the debtor. He should be present either in person or by proxy, where there is sufficient reason preventing his presence in person.

What if the bankruptcy is declared on death of the debtor? You might have answered that “The heirs of the debtor should be called up on to be present”. If your answer is so, you are correct. As we have discussed earlier, there is possibility of adjudication of bankruptcy of a debtor even if he has already passed away. In other words, the fact that the debtor died could not bar adjudication of bankruptcy where the requirements are fulfilled. In some other cases, the debtor may die after the declaration of his bankruptcy but before the inventory of his properties is not yet accomplished. In such cases, the heirs of the deceased debtor are to be summoned to be present in the place and at the time of inventory. Where the inventory has been started before the death of the debtor, the heirs are to be summoned duly to be present at the completion of the inventory (Read Article 1016 of the Commercial Code).

During the inventory, the properties which are made not the subject of affixing a seal are to be identified and verified. As we have discussed earlier, the properties to which a seal would not be affixed or even if affixed, should be removed are those necessary for the subsistence of the debtor and his family, perishable goods, and those necessary for continued operation of the business. These properties of the debtor have to be verified.

The inventory of properties of the debtor is to be prepared in two copies. Both of the copies should be original ones. One of the two copies has to be deposited with the court registry and the other copy remains in the hands of the trustee. Why do you think one of the copies is to be deposited with the registry? You might have guessed why it is. It could be for the purpose of legalizing the document and to retain it so that the trustee or any other person could not change it after the inventory is made. Even if there is a need for change, it would be with the knowledge of the court that change could take place.

Otherwise, if it simply remains in the hands of the trustee or other persons, there would be a loop hole for modification.

Do you think that the trustees are all-rounded persons? I hope your answer will be “No”. If you answered so, that is great. It could be very rare in occurrence that the trustees are experts in all areas of knowledge and skill. As a result, where there is a need for making the inventory and valuation of the assets of the debtor, the trustees can employ suitable persons. As regards some of the properties of the debtor, a special knowledge or skill may be required for valuation or inventory. In such cases, as the trustees could not discharge such functions, it is necessary that they employ another person who can properly do it. Therefore, it seems logical to leave possibility for the trustees to look for the assistance of suitable persons. However, it has to be noted that the trustees cannot employ suitable persons as it pleases them. There should be always the consent of the commissioner. The ultimate power of approval is vested with the commissioner.

Do you agree that the public prosecutor has extended powers in relation to inventory of properties of the debtor? In order to answer the question, now read the provisions of Article 1017 of the Commercial Code.

*Art. 1017- Rights of public prosecutor*

The public prosecutor has the right to be present at the preparation of the inventory and to inspect at any time any documents, books, or papers in bankruptcy proceedings.

As per the above-mentioned Article, the public prosecutor has the power to be present at any stage of the inventory. Moreover, it is within the power of the public prosecutor to inspect any document, book or paper of the debtor related to the bankruptcy proceeding. Note here that it is at any time and any of the documents, books, or papers of the debtor that the public prosecutor can inspect. Here it seems that the power is a bit extended. One can also question the rationale behind such power. Is it because it is always assumed that

bankruptcy would have a criminal element that the public prosecutor is given such power or is it because of other reason.?

After the accomplishment of the inventory of the properties of the debtor, all the assets are to be handed over to the trustees. Why all the properties and documents of the debtor are to be handed over to the trustees is because it is the trustees who are responsible for the administration of the estate. Moreover, the trustees represent the debtor in the bankruptcy proceeding. The fact that the assets are handed over is to be noted at the foot of the inventory document. After such note is made, as we have discussed earlier, one original copy of the inventory is to be deposited with the registry of the court.

## **CHAPTER SUMMARY**

We have discussed in this Unit that there are different conservatory measures to be taken by the different responsible bodies. The first step in the measures is to close the books and accounts of the debtor. There are other steps to follow such closure of books and accounts, such as preserving the rights of the debtor and effecting registration of mortgage in the name of the bankrupt estate. In preserving the rights of the debtor, the trustees are to endeavor to collect debts payable to the debtor and claim properties of the debtor from other persons.

Where an immovable of another person is produced to secure the debts such person owes to the debtor, the trustees have to effect registration of mortgage in the name of the bankrupt estate. They are also to effect registration of mortgage in the name of the estate as regards the immovable existing at the time of adjudication of bankruptcy of the debtor. Mortgage also has to be registered on the business of the debtor.

We have also discussed that provisional measures are to be taken in relation to the properties of the bankrupt person. Accordingly, the important measures are affixing seal and making inventory of the properties of the debtor. It is not on all of the properties, but with the exception of certain that the seal is to be affixed. Those which are perishable,

needed by the debtor and his family and those necessary for the continued operation of the business shall not be sealed.

The seal has to remain on the properties only for a short period of time. After removal of the seals, inventory of the properties has to be made. The inventory has to be prepared in two copies and finally the properties have to be handed over to the trustees.

## **REVIEW QUESTIONS**

1. What necessitates the closing of the books of account of the bankrupt immediately after the trustees assume their office?
2. Comment on the title and content of Article 1005.
3. Discuss the measures of affixing seals and making inventory.
4. Enumerate the provisional measures that may be taken.
5. Identify the responsible persons to take the conservatory measures and their responsibilities.
6. List the steps in conservatory measures.
7. What possible measures is the public prosecutor going to take so that s/he can secure attendance of the debtor? Why?

## CHAPTER FIVE

### PROOF OF DEBTS

#### **Introduction**

Bankruptcy proceeding consists of several steps. One of these steps is the step of proving debt. As we have discussed repeatedly, the overall purpose of the bankruptcy proceeding is to make available proceeds of sale of properties of the debtor for the creditors. Any person who claims that he is a creditor of the debtor could not participate in the distribution merely because he demanded so. In order to be considered as the creditor of the debtor, any person has to assure that he is really the creditor. The fact that a person is creditor of the debtor is to be ascertained at the step of proof of debts. In this unit we are going to discuss the step of proving debts.

At this step, the creditors are expected to present their proof before the trustees and get it accepted so that they will later participate in the distribution of the proceeds of sale of properties of the debtor. The process of proving debts involves several procedures. The proof is to take place in the presence of the bankrupt person and the creditors' committee.

This unit is divided into five sections. The first section is on the procedures of proof of debts. In this section, we will discuss the several steps to be taken in proving the debts. The second section deals with the responsibility of parties jointly liable with the debtor. In this section, we will focus on the duties of persons who have already suspended payments and those who did not suspend payments, who are joint debtors along with the bankrupt person. The third section is devoted to the rights of creditors secured by movable properties of the debtor. The fourth section is on the rights of creditors whose right is secured by mortgage on the immovable or business of the bankrupt person. In this section, we will mainly focus on the comparison between the rights of creditors secured by the movable and the immovable or business of the debtor. The fifth (last) section is devoted to recovery. In this section, we will discuss which rights of third parties are recoverable after the bankruptcy declaration of the debtor.

## **Objectives:**

At the end of studying this Unit, you should be able to:

- list down the steps to be taken in proving debts;
- explain each of the steps in the process of proving debts;
- identify the persons responsible to prove debts;
- discuss the duties and responsibilities of the persons in charge of the proof;
- explain which category of creditors should prove debts;
- discuss what proof is;
- explain the duties of parties jointly liable with the bankrupt person;
- identify the rights of creditors secured by movable properties of the debtor;
- identify the rights of creditors secured by mortgage on immovable and the business of the bankrupt person;
- discuss the concept of recovery in bankruptcy proceedings, and
- dispose practical cases in relation to proof of debts.

### **5.1. Procedures of Proof**

As has been mentioned in the introductory part of this unit, the proof of debts consists of several procedures. The mere fact that a person, who claims to be creditor of the bankrupt person, has produced certain documents or evidences could not suffice. Rather the trustees, with the support of the commissioner and the court, should discharge certain functions. The important procedures to be followed in the process of proving the debt are: producing proof, verifying the debt, preparing inventory of debts, drawing up the final inventory of debts, and admission of creditors coming later. Now let us discuss each of these procedures in the following paragraphs.

## **I) Producing Proof**

After the date of adjudication of bankruptcy, the fact that the debtor is bankrupt is to be declared and publicized as per the provisions of Article 983 of the Commercial Code. After such declaration and publication, the persons who claim to be creditors of the bankrupt person are to be called up on to produce their proof.

When do you think such persons could produce their proof? You might have tried to answer the question. Is that what you did? If so, that is great. Now read the provisions of Article 1042 of the Commercial Code.

### *Art. 1042- Notice to creditors*

- (1) Creditors who appear on the balance sheet and who have not produced proofs *within fifteen days from the adjudication* shall be requested by the trustees to produce their proofs.
- (2) Such request shall be made by notice in a newspaper empowered to receive legal notices and in the Official Commercial Gazette. Such notice in the Gazette shall refer to the issue number of the newspaper containing the legal notice issued under this Article. Notice to creditors by letter shall also be sent.
- (3) Proofs shall be produced within fifteen days of the publication in the Gazette.

As you read from sub-article (1) of the above cited provision, particularly the italicized part, the persons who claim to be creditors should produce their proofs within fifteen days from the date of adjudication of the bankrupt person. In other words, the fact that the bankruptcy of the debtor is declared and publicized serves as notice to the persons who claim to be creditors. In all cases, the identity and address of all the creditors may not be found on the documents and papers of the bankrupt person on the day of adjudication of bankruptcy. Sometimes, a person may have sufficient proof to the effect that he is the creditor of the bankrupt person even if his name does not appear on the papers and

documents of the latter as they appear on the date of adjudication. Therefore, there is a need to identify those whose name appears on the documents and papers of the bankrupt person and those who do not appear thereon.

As regards the creditors whose name appears on the balance sheet, it could be easier to find their identity and address. Therefore, such creditors are to be requested to produce their proofs within fifteen days if they have not yet done so. Where the creditors have already produced their proofs within the fifteen days period from the adjudication of the bankrupt person, then there is no need to give notice. But, where their proof is not produced within such period, a notice period of another fifteen days starts to run. The trustees are responsible to make a request to that effect to such creditors. The notice has to be made in a newspaper through which legal notices are to be released and in the Official Commercial Gazette. In addition to these publications, notice to the creditors is to be made by a letter. As has been mentioned earlier, the identity and address of such creditors is more likely to be known and, therefore, the notice by letter is to be sent to such address.

Do you agree that the creditors whose name appears on the balance sheet are given privilege while those whose name does not appear are not entitled to such privilege? I hope your answer will be “Yes”. If it is so, you are right. As we can read from the provisions of the above-cited Article (Article 1042), those whose name appears on the balance sheet and who did not produce proof within the fifteen days following the date of adjudication are to be notified to produce within fifteen days. Such creditors are given totally a notice period of thirteen days, while creditors whose name does not appear on the balance sheet are given only fifteen days. Where they failed to produce proof within such period, it is to be presumed as if they waived their rights. But in the case of creditors whose name appears on the balance sheet, even if they failed to produce their proof within the first fifteen days period, they are not presumed to have waived their rights. Rather, another fifteen days period is to be given within which period they are expected to produce their respective proofs.

Whatever the time of producing the proof is, the creditors are to produce their proof to the trustees. Each of the creditors has to show what he claims from the bankrupt person. Where a proof is produced by a creditor, the trustees are expected to give receipts for them. The trustees are to keep the proof up until the closure of the bankruptcy proceedings. After closure of the bankruptcy proceedings, the trustees have to return the proofs of each of the creditors. But the responsibility of the trustees in relation to the proofs ends at the end of a year's period from the date of closure of the bankruptcy proceedings.

Different issues related to the production of proof could be raised. One of the issues could be as to what constitutes proof. Would you mind guessing what has to be considered and accepted as proof? If you have tried, that is wonderful. By proof we refer to different documents and papers that can be used to ascertain that the person is a creditor of the bankrupt person. Accordingly, proof could be negotiable instruments, contract documents, securities, receipts, and the like. You see, if the creditors produce witnesses to testify the fact that they are creditors of the bankrupt person, that could not be accepted as a proof. Oral evidence is not acceptable but documents.

Another issue to be raised is what is to be proved? In other words, which debts and liabilities are provable? Have you tried to answer this question? If so, that is great. In principle, it is all the debts and liabilities, present and future (certain or contingent), to which the debtor is subject on the date of declaration of bankruptcy that are provable. Such debts or liabilities may include any compensation for labour work done, and obligation to pay money. Generally, express or implied engagements, agreements, or undertakings made by the bankrupt person to make payment or capable of resulting in the payment of money are provable. The payment could be regarding an amount fixed or unliquidated, present or future; certain or dependent on anyone contingent capable of being ascertained by fixed rules. In all cases, however, it has to be noted that the debt to be provable has to be valuable or estimated in terms of money.

By contingent debt we refer to a debt which is not certain to arise during the date of proof. It depends on the occurrence or non occurrence of a certain condition. The creditors may prove full value of their contingent debts. What if the amount to which the bankrupt person is indebted is not ascertained on the date of proof? Did you try to answer the question? If so, that is great. In cases where the amount is not ascertained on the date of proof, the trustees must make an estimate.

The debts or liabilities which are not subject to proof are such as unenforceable contracts founded on illegal or immoral considerations and claims barred by period of limitation. The debts incurred after the adjudication of bankruptcy of the debtor without the authorization of the commissioner are also non-provable. Moreover, debts which are not valuable or could not be estimated in terms of money are also non-provable. As we have discussed earlier, in order to be made the subject of proof, all the debts and liabilities should be valued or estimated in terms of money. Therefore, one who is entitled to a right which could not be valued in terms of money cannot prove because he has no payable claim against the bankrupt person.

## **II) Verifying the debt**

The next procedure after the proofs are produced by the creditors is verifying the debts. In this procedure the trustees are to call upon the creditors' committee and the bankrupt person to be present. This implies that the mere fact that one has produced proof before the trustees by itself shall not guarantee that such a person is the creditor of the. It has to be bankrupt person verified by the appropriate persons that he is really a creditor entitled to a legal claim against the bankrupt person.

The process of verification is within the responsibility of the trustees. In fact the creditors' committee or its representative and the bankrupt person are to be called up on to be present at the time of verification. It seems logical to demand the presence of these two bodies. The presence of the debtor is justifiable in that if he verifies the debt because it was him who entered into the transactions from which the debt arose, that facilitates the

bankruptcy proceedings. In addition to that, the presence of the bankrupt person would deter the persons who claim to be creditor from presenting proof which is not agreed with the debtor. Due to his presence, the bankrupt person can react so that his rights will be protected. The bankrupt person could be present because of his own motion or due to summons by a registered letter by the trustees. Similarly, the presence of the creditors' committee or its representative is justifiable in that the interests of the creditors can be protected due to such presence.

What if a debt is queried at the time of verification? In some cases the proof produced by the creditor may not be partially or fully accepted by the bankrupt person or the trustees. In cases where a debt is queried, the trustees should inform the creditor to reply to the queries. The information is to be made by a registered letter. But the creditor is not necessarily required to reply in a written form. He can reply either orally or in a written form. The time within which the creditor is expected to reply is only eight days from the creditor got informed about the query (Read Article 1043 of the Commercial Code).

*Art. 1043- Verification of debts*

- (1) Debts shall be verified by the trustees in the presence of the creditors' committee or its representative, where such committee has already been formed, and of the debtor, whether he presents himself of his own motion or on being summoned by registered letter.
- (2) The inventory of debts when finalized shall be counter-signed by the commissioner.
- (3) Where a debt is queried by the trustees in whole or in part, the trustees shall inform the creditor by registered letter, and he shall reply to the queries orally or in writing within eight days.

**III) Preparing inventory of debts**

After the creditors have produced their respective proof and such proof is verified by the trustees in the presence of the bankrupt person and the creditors' committee, the next

procedure is to prepare inventory of the debts. As we have discussed earlier, the trustees are responsible to prepare inventory of properties of the debtor. Similarly, it is within the responsibility of the trustees to prepare the inventory of debts as one part of the process of proving debts. Now, read the provisions of Article 1044 of the Commercial Code, which reads as follows:

*Art. 1044- Deposit of inventory in registry*

- (1) Where the debts have been proved, the trustees shall deposit the inventory of debts with the registry, showing the proofs admitted and the proofs rejected.
- (2) They shall also send to the commissioner a list of creditors claiming special preferences over movables.

As per the above cited provision, at the end of production of the proofs by the creditors, the trustees are to prepare the inventory of debts and deposit such inventory with the registry of the court. Where the inventory is deposited with the registry of the court, it gives opportunity for any interested person to look into such inventory. The trustees have to state in the inventory the proofs which are admitted and those which are rejected. As mentioned earlier, all the proofs produced by the person claiming to be creditor of the bankrupt person could not be accepted. Some of the proofs may be found dubious and, therefore, to be rejected by the trustees due to the recommendation of the creditors' committee or the bankrupt person. Therefore, the inventory deposited with the registry should clearly indicate the proofs admitted and those rejected because of several reasons. It is also the responsibility of the trustees to send the list of creditors claiming special preference on the movables of the bankrupt person. Such list is to be sent to the commissioner so that he can determine the level of priority among the different categories of creditors.

How do you think can the creditors know that the inventory is deposited with the registry of the court? Did you answer "When they are informed?" If your answer is so, you are correct. The fact that the inventory is deposited with the court registry has to be informed

to the creditors. It is the responsibility of registrar of the court to inform the creditors. The registrar is expected to inform the creditors by using a newspaper empowered to receive legal notices and the Official Commercial Gazette. The registrar should also give notice about the rejected debts by registered letter. The creditors who produced a proof which is rejected are entitled to get a registered letter that notifies the debts are rejected because of certain reasons.

The inventory prepared and deposited with the court registry would not be found perfect in all aspects. Sometimes it might have problems and therefore either the creditors or the bankrupt person himself may get dissatisfied with it. In such cases, any person who is not satisfied with the inventory should present his claim to the court. Note here, however, that the right to bring claim is not open to all of the creditors. It is a right of only the creditors who produced proof or whose name appears on the balance sheet. Apart from that the bankrupt person can also present claim if he is not satisfied by the inventory deposited with the court registry. Such claim has to be lodged within a period of eight days from the notice of deposit of the inventory in the official Commercial Gazette.

#### **IV) Drawing up the final inventory of debts**

The task of preparing the final inventory is that of the commissioner. After waiting for expiry of the eight days period, within which the claim is to be lodged, the commissioner can prepare the final inventory of debts. The final inventory of the debts has to take into account the claims lodged with the court registry, if there is any. The claim may be decided either in favor of the claimant or otherwise. Where the court passed judgment against the one who lodged it, the inventory will not include such debt. Where the judgment of the court is in favor of the one who lodged it, then the inventory shall include such creditor in case the claim is made by a creditor. But where it is the bankrupt person who lodged the claim, then the debt could be excluded from or added to the inventory, as the case may be.

Where the claim of a creditor is accepted, the trustees are to register such creditor's claim as one of the uncontested claim. In other words, such debt forms part of the debts admitted and the amount has to be registered by the trustees in the list of creditors.

Where the debt is contested, what do you think happens? In case where a debt is contested, a hearing is to take place and the fate will be determined thereby. The registrar of the court is responsible to refer the debts that are contested to the first hearing. Before the date of the hearing, the persons who claim to be creditors of the bankrupt person and as a result produced the proof have to be notified in advance. They have to be duly notified by a registered letter five days prior to the hearing. At the hearing, the reports of the commissioner are to be considered along with the reply of the parties concerned.

Sometimes it may take longer time to decide on debts contested. In such cases, it is the discretion of the court to pass interlocutory order. By such an order, the court can allow such a creditor to participate in the bankruptcy proceedings temporarily. This is to mean that the participation of the creditor is not as such permanent. Where the court gradually finds that he is not a creditor, then he is to lose rights to accrue from being a creditor. The court may fix the amount of debt in respect of which the creditor could participate in the bankruptcy proceeding. The amount is to be fixed by the court as there are no determined standard criteria to that effect. For instance, assume that W/ro Aselef is declared bankrupt. Ato Melaku produced a proof after being notified of the adjudication of bankruptcy of W/ro Aselef. Part of the proof he presented was contested. The total claim of Ato Melaku was 60,000 Birr. Of this claim, the evidence presented can prove only 5,000 Birr. As a result, the court can pass an interlocutory order to the effect that Ato Melaku provisionally participate in the bankruptcy proceedings in respect of the 5,000 Birr. Where the court has made an interlocutory order, the registrar of the court has to notify to the creditors concerned. The notice has to be made by registered letter within three days from the date of the order. Read Article 1049 of the Commercial Code:

*Art. 1049- Provisional admission*

- (1) The court may grant an interlocutory order allowing a creditor whose claim is contested to join in bankruptcy proceedings in respect of such amount as the court may decide.
- (2) The registrar shall inform by registered letter the parties concerned within three days.

What if the security a creditor is holding is contested? As we have discussed earlier, the mere fact that a person is in possession of properties of the debtor would not be sufficient to prove that such person is the creditor. Where a person is holding the properties or title to property of the debtor in the form of security, while the debt is admitted, the security may be contested. In such cases, the creditor would not be denied the right to participate in the bankruptcy proceedings. He is also not to wait until an order is made on the contested security. Rather the creditor participates in the bankruptcy proceedings as if he were unsecured creditor. In other words, he is to be entitled to proportionate distribution of the proceeds of available assets of the debtor. Read the provisions of Article 1051 of the Commercial Code:

*Art. 1051- Creditors whose security is contested*

Where a creditor holds a security in *rem* and only the security is contested, such creditor may join in the proceedings as an unsecured creditor.

Sometimes an objection contesting a debt may be made by an interested person, particularly the creditor or the creditors' committee. Such an objection could be one that can be decided on within a short period of time or it may take longer time depending on the nature of the objection. The question then remains as to what the court could do in case an objection is forwarded. In order to answer this question, read the provisions of Article 1050 of the Commercial Code, which reads as follows:

*Art. 1050- Stay of proceedings or disallowance of objection*

- (1) Where an objection contesting a debt is lodged and such objection may cause delay, the court shall decide whether to stay bankruptcy proceedings until the objection is decided on by the ordinary civil court having jurisdiction or to disallow the objection. Where the court disallows the objection, it may at the same time make an order under Art. 1049.
- (2) Where a debt gives rise to criminal proceedings, the court may order a stay of bankruptcy proceedings. Where the court disallows the objection, it may not make an interlocutory order and the creditor holding the contested debt may not join in the proceedings until judgment in criminal proceedings has been given.

As per the provisions of the above-cited Article, the court may have two options. One of the options is that the court can decide the bankruptcy proceeding to stay for some defined period of time. The proceeding is to be ordered to stay until the objection is decided up on by another civil court having jurisdiction over the matter. Note here that it is not the bankruptcy court that is to decide on the objection. Rather it is an ordinary court having jurisdiction over the matter. This also implies that the legislature intended that bankruptcy proceeding has to be handled by a special court like the labour court.

The other option for the court is to disallow the objection. Where the court finds that the objection can delay the bankruptcy proceedings, it can disallow the objection. Note, however, that the court cannot simply disallow the objection without having justifiable reason to that effect. Where the objection is disallowed by the court, it can make an interlocutory order to the effect that the creditor be provisionally admitted in respect of some part of the debt.

Sometimes, the debt of the creditor may give rise to a criminal proceeding. In such cases, the court is to order a stay of the bankruptcy proceedings until the court decides on the criminal matter. Apart from stay, the court may also disallow the objection, in which case

it cannot make an interlocutory order. Such order can be to the effect that the creditor participates in the bankruptcy proceedings temporarily in respect of a certain amount of the debt. In other words, where the court has disallowed the objection for the reason that the debt gives rise to criminal proceedings, the creditor would not participate in the bankruptcy proceedings until judgment in the criminal proceeding is made.

#### **V) Admission of creditors coming later**

As we have discussed earlier, the creditors who have a claim against the bankrupt person are expected to produce their respective proof within a specified period of notice. Those whose name appears on the balance sheet are given a notice period of utmost thirty days, but the other creditors are required to produce within fifteen days from the date of publication of bankruptcy. But because of different reasons, some of the creditors may not produce their proof on time. The question then remains as to what happens to the right of such creditors. In other words, should such creditors totally lose their right against the debtor or should they be given chance to claim their right? Now read the provisions of Article 1052 of the Commercial Code, so that you can answer the question.

*Art. 1052- Creditors not having lodged proof within the specified period of time*

- (1) Creditors failing to lodge their claim within the specified period of time ***shall not share in any distribution*** but they may lodge an objection until final distribution of the residue and shall bear the costs arising out of such objection.
- (2) Any such objection shall not suspend any distribution ordered by the commissioner.
- (3) Where further distributions are made, such creditors shall share therein to the extent of an amount provisionally fixed by the court and retained in reserve until adjudication upon their objection.

As per the provisions of sub article (1) mentioned above, the creditors would not participate in any distribution. What they can do is to present an objection until the

residue is distributed. If they are simply to lodge an objection but not participate in the distributions, one may question as to what would be the advantage of such objection. The creditors are responsible to bear the costs of their objection. But the essence of sub article (3) of the above cited Article is different from that of sub article (1). The former provides that creditors who lodge their claim after the specified period of time shall share in the subsequent distributions. They are not, in fact, free to share in the subsequent distributions to the extent of their claims. It is only to the extent of an amount provisionally fixed by the court. That amount to be fixed by the court has to be retained in reserve until adjudication upon the objection.

If the creditors are to share in the subsequent distributions, how could it be reconciled with the essence under sub article (1) which says “shall not share in any distribution”? In order to reconcile the two sub- articles, it is better to interpret the italicized part of sub article (1) to refer to any distribution which is already ordered by the commissioner at the time when the creditor produces his proof. Otherwise the two sub-articles contradict each other. Another possibility of interpretation is to apply the provisions of the above cited provision to creditors who failed to lodge a claim in respect of the inventory of debts. If they fail to lodge the claim within eight days and did so after expiry of the period, they can participate only in the subsequent distributions to the extent of an amount provisionally fixed by the court.

What if there are creditors admitted subsequently? Such creditors shall not participate in distributions already ordered by the commissioner. But if there is another distribution later, such creditors shall share in such distributions. When they participate in the subsequent distributions they would be entitled to the share which is lost in the first distribution. For example, assume that Ato Goshu is the bankrupt person. Ato Musse, Ato kemal, W/ro Kelemua and W/ro Yeshe are the creditors of the bankrupt person. All these creditors have produced their proof in due time and this is admitted by the trustees. Ato Tesfaye, another creditor of the bankrupt person, produced his claim after the specified period and is admitted by the trustees. At the time when Ato Tesfaye is admitted, the commissioner has ordered for the distribution of 20,000 Birr to the creditors admitted. In

this case, Ato Tesfaye could not share in the distribution of the 20,000 Birr. After some time, the commissioner ordered for the distribution of 30,000 Birr among the creditors. In this case, Ato Tesfaye can participate in this distribution and shall be entitled to get what he lost in the previous distribution.

## **5.2. Parties Jointly Liable with the Bankrupt Person**

There might be several instances where a bankrupt person becomes jointly liable with another person towards third party creditors. The persons who are joint debtors could be either persons who entered into the course of the bankruptcy proceedings or those who are not in that course. In this section, we are going to discuss the rights and obligations of the creditors of such joint debtors and guarantors.

Where the bankrupt person, along with another person who has suspended payments, becomes a joint debtor of the creditor, such creditor is entitled to prove in the bankruptcy of both debtors. For example, assume that Ato Nahom is declared bankrupt on January 5, 2005. Two months before his declaration of bankruptcy, Ato Nahom and W/ro Tenaye jointly indebted towards Ato Mohammed. A month after the date of declaration of bankruptcy of Ato Nahom, W/ro Tenaye also suspended payments. In this case, the joint debtors are Ato Nahom who is declared bankrupt and W/ro Tenaye, who has suspended payments. As a result, the creditor (Ato Mohammed) can prove in the bankruptcy of both debtors. As far as the rules of joint debtors are concerned, the creditor is entitled to claim full debt from both of the joint debtors either severally or jointly. For example if three persons are jointly indebted to Ato Assefa to the extent of 75,000 Birr, Ato Assefa can claim 75,000 Birr from each of the joint debtors or from all of them jointly. But as far as the rule of bankruptcy law is concerned, where the debtor is jointly indebted with another person who has suspended payments, the creditor is entitled to prove in the bankruptcy of both debtors.

Do you think that the creditor can claim full amount of the debt jointly guaranteed by the bankrupt person and another person who has suspended payments? To answer the

question, now read the provisions of Article 1055 of the Commercial Code, which reads as follows:

*Art. 1055- Proof of claims jointly and severally guaranteed*

A creditor whose claim has been endorsed or guaranteed jointly and severally by the bankrupt and other persons who have suspended payments may prove in all the estates for the nominal value of his claim and share in the distributions until his claim is fully satisfied.

As you read from the above cited Article, where a persons claim is guaranteed or endorsed by several persons, including the bankrupt person and other persons who have suspended payments, the creditor can prove in the bankruptcy of all the joint debtors. In other words, the creditor can be creditor of all the persons and produce his proof in the bankruptcy of all joint debtors. As a result, he can share in the distribution of all the estates of the bankrupt joint debtors. For instance, assume that Ato Ayele, Ato Nigusse, and Ato Tafesse were joint debtors of W/ro Tsige to the extent of 165,000 Birr. Ato Tafesse is declared bankrupt on June 10, 2005, while the other debtors have already suspended payments. In this case, as all the three persons are joint debtors of W/ro Tsige, because they guaranteed the debt jointly, the creditor can produce her proof in all the three bankruptcies. That is she becomes creditor in the bankruptcy of Ato Tafesse, Ato Nigusse, and Ato Ayele.

We have seen that the creditor can prove in the bankruptcy of all the joint debtors. Do you think that the creditor can get more than his claim from all the several bankruptcies? I hope your answer will be “No”. If you answered so, that is great. As you know, no person should unlawfully enrich himself by getting undue payments. If the creditor collects more than what he claims from the joint debtors, that amounts to unlawful enrichment because he has collected undue payment. The excess is what should not have been paid to him and therefore would not be retained by the creditor. For instance, in the above given example, W/ro Tsige produced a proof for the whole value she claims (165,000 Birr) in each of the bankruptcies and collected at the time of distribution

100,000 Birr from the estate of Ato Ayele, 120,000 Birr from the estate of Ato Tafesse, and 110,000 Birr from the estate of Ato Nigusse. Totally, W/ro Tsige collected 330,000 Birr from the bankruptcy of the three joint debtors. What she claims from the joint debtors is only 165,000 Birr. She has collected 165,000 Birr in excess of what she is entitled against the joint debtors. Therefore, W/ro Tsige should not unlawfully enrich herself with this excess amount of money. It would not be justified if she gets advantage of the situation of bankruptcy of the joint debtors. One should not manipulate the situation of bankruptcy of his debtors to collect excess money to which he would not have been entitled otherwise.

Do you think that the excess goes into the bankrupt estates? Did you answer “Yes”? If your answer is so, it is not correct. Where the creditor has collected, from the several estates, more than what he claims from the joint debtors, the excess would not be paid back to the bankrupt estates. Rather it has to devolve upon the persons having the others as guarantors, in the order of their liability (Read Article 1056 of the Commercial Code). Therefore, it is clear that the excess shall not go into the several bankrupt estates or to be distributed among the creditors of the several bankruptcies.

Sometimes, it happens that one of the estates pay more than its share in the debt. Normally, the rule of joint debt is that in the absence of clear stipulation, all the joint debtors share equally in the debt among themselves. But where there is clear stipulation about the share of each of the parties, each is liable only to that extent. This is as regards the share among them but not in respect of the claim of the creditor. Where the bankrupt and other persons who have suspended payments have paid more than what one is expected, can the one who paid more than his liability claim from the bankruptcy of the other? For example, assume that Ato Getu and Ato Atnafu are joint debtors of Ato Ketema to the extent of 20,000 Birr. As between them it was agreed that Ato Getu would share 4,000 Birr and the remaining 16,000 Birr would be the debt of Ato Atnafu. During the bankruptcy proceedings, Ato Ketema proved in the bankruptcy of both debtors. He produced proof of 20,000 Birr in each of the bankruptcies and collected 12,000 Birr from the bankruptcy of Ato Getu and only 9,000 Birr from the bankruptcy of Ato Atnafu. In

this case, the estate of Ato Getu paid more than what Ato Getu was indebted as per the internal agreement between Ato Getu and Ato Atnafu. In this case, can the estate of Ato Getu claim what it has paid in excess from the estate of Ato Atnafu? If you read the provisions of Article 1056 of the Commercial Code, none of the estates can claim from the other state the excess paid from it. Unless what the creditor collected is exceeding what he claims the estates would not pay to each other. Even if there is excess, it should devolve upon the persons having the others as guarantors, in the order of their liability.

What do you think would happen if one or more of the joint debtors are a person who has not suspended payments? I am sure that you answered “No right to prove in several bankruptcies”. If you answered so, you are correct. In cases where the other joint debtor other than the bankrupt person is a person who has not suspended payments, the creditor would have no right of proving in several bankruptcies. He would have the right to prove only in the bankruptcy of the person who is declared bankrupt. As the other joint debtors are not bankrupt or suspended payments, the creditor would have no right to prove in several bankruptcies. No proof in respect to persons who are not declared bankrupt.

What if the creditor has collected partial payment from one of the joint debtors, who has not suspended payments? As you know from your study of the Law of Contracts, any payment made by one of the joint debtors discharges all the joint debtors to that extent. For instance, where the total liability of the joint debtors is 23,000 Birr, if one of the debtors pays 2,000 Birr to the creditor, all the joint debtors are relieved to that extent towards the creditor. As a result, the creditor can claim either jointly or severally only 21,000 Birr. Similarly, in case where the bankrupt person and another person, who has not suspended payments are joint debtors of a certain creditor and the debtor who has not suspended payments has made partial payment before adjudication of bankruptcy, the bankrupt person also would be relieved to that extent towards such creditor. The creditor, therefore, would prove only for the remaining amount of his claim. For example, assume that Ato Gutema is the bankrupt person. Ato Gutema and Ato Kifle were the joint debtors of W/ro Mulunesh to the extent of 45,000 Birr. Before the adjudication of bankruptcy of Ato Gutema, Ato Kifle paid 13,000 Birr to W/ro Mulunesh. In this case, W/ro Mulunesh

can prove only to the remaining 32,000 Birr in the bankruptcy of Ato Gutema because Ato Gutema is relieved to the extent of 13,000 Birr which is paid by Ato Kifle.

Does the fact that one of the joint debtors is adjudicated bankrupt relieve the other debtors, who have not suspended payments from liability for the remaining amount where there is partial payment? In order to answer this question, now read the provisions of Article 1057 of the Commercial Code, which reads as follows:

*Art. 1057- Creditors having received payment on account before suspension of payments*

- (1) Any account paid prior to suspension of payments to a creditor whose claim is jointly and severally guaranteed by the bankrupt and other persons shall be deducted in paying his claim. He shall retain, for what remains due to him, his rights against such other persons or guarantors.
- (2) Any person jointly and severally liable or any guarantor, who has paid any amount on account towards the claim, shall be entitled to prove his claim to the extent of the amount so paid.

As you read from sub-article (1) of the above cited Article, the mere fact that one of the joint debtors is declared bankrupt and part of the debt is paid before the adjudication of bankruptcy would not relieve the other debtors from liability for the remaining amount of debt. The creditor is, apart from proving in the bankruptcy of the joint debtor who is declared bankrupt, entitled to claim the remaining amount from the joint debtors who are neither declared bankrupt nor have not suspended payments. For example, assume that W/ro Tenaye is adjudicated bankrupt. Before the adjudication, Tenaye and Ato Hailu were jointly indebted to Ato Nuri to the extent of 35,000 Birr. Ato Nuri collected 10,000 Birr from Ato Hailu before the adjudication of bankruptcy of W/ro Tenaye. In the bankruptcy proceedings of W/ro Tenaye, Ato Nuri produced a proof for the remaining 25,000 Birr. The mere fact that Ato Nuri has proved in the bankruptcy of W/ro Tenaye and he has already received 10,000 Birr from Ato Hailu would not relieve Ato Hailu from liability for the remaining 25,000 Birr. The creditor (Ato Nuri) retains his right against Ato Hailu.

Where one of the joint debtors has paid to the creditor a certain amount of the joint debt, such person can prove in the bankruptcy of the other joint debtor to the extent he paid. As the debtor who paid is a person who has neither suspended payments nor declared bankrupt, he has the right to claim what he paid to the creditor. For example, assume that Ato Fikre is the bankrupt person. Ato Fikre and w/ro Rahel were the joint debtors of Ato Asmamaw to the extent of 25,000 Birr. W/ro Rahel neither suspended payments nor declared bankrupt. She paid 7,000 Birr to the creditor before the date of adjudication of bankruptcy of Ato Fikre. In this case, W/ro Rahel can prove in the bankruptcy of Ato Fikre to the extent of 7,000 Birr. Though she is one of the joint debtors, as she paid part of the joint debt, she can prove to the extent she paid in the estate of the other joint debtor, whose bankruptcy is underway.

### **5.3. Rights of Creditors**

#### **5.3.1. Rights of Creditors Secured by Movable**

There might be different reasons for why a person can demand security. Before he is declared bankrupt, the debtor might have produced movable properties in the form of security to his creditors to assure payment of the debts. Do you remember the type of security to be created by producing movable properties? Just to remind you, it is known as pledge. Where the bankrupt person is the pledger, who produced his movable or that of another person, and the creditor is the pledgee, who took possession of the movable, as a result of adjudication of bankruptcy of the pledger what are the rights of the creditor? In this section, we are going to discuss the major rights of the creditor whose claim is secured by movables.

The creditor, whose claim is secured by movables, is entitled to several rights. In fact the rights are related to the property and are exercisable during the bankruptcy proceedings. The major rights are the right to: get payment of his claim, sale the movable property,

prove for the difference, and to enjoy preference. Now let us discuss each of these rights in the following paragraphs.

#### **I) Right to get payment**

A secured creditor is distinct from ordinary creditors because he is holding a certain movable property handed over to him with the view of assuring payment of the principal debt. As the movable property is produced in the form of assurance for the payment of the principal debt which the bankrupt person owes the creditor, the latter is entitled to payment of the debt preferentially.

##### *Art. 1058- Guaranteed creditors*

Creditors whose claim is secured by pledge shall be entered in the inventory for purposes of information only. With the authorization of the commissioner, the trustees may at any time pay for and redeem the property pledged, for the benefit of the estate.

It is the responsibility of the trustees to pay to the creditor. However, the trustees are not free to decide whether to pay to the creditor or not. The decision has to be approved by the commissioner. Without permission of the commissioner, the trustees cannot take measures of paying to the creditor. As per the above cited provision, the trustees are to pay and redeem the movable property in the hands of the creditor. As far as the concept of redemption is concerned, it refers to the situation of buying back. Where the trustees, being authorized by the commissioner, decide to pay and redeem, that amounts to buying back the movable property which is under the ownership of the bankrupt person.

Where it is another person who produced his movable property to secure the debts of the bankrupt person, it would not amount to redemption. As the bankrupt person is not the owner of the movable produced in the form of security, it would not amount to redemption where the trustee pays and takes the movable. As we have discussed earlier, the properties under possession of the debtor that are to be realized are those to which the

debtor is the owner. Otherwise, all properties belonging to other persons are to be given to their real owner. Accordingly, after the trustees have paid and taken back the movable produced in the form of security, the real owner can collect it. For example, assume that Ato Gebre is declared bankrupt. Before his declaration of bankruptcy, he was indebted towards Ato Messay to the extent of 5000 Birr. In order to guarantee his debt towards Messay, Ato Getachew produced his movable property (20 grams of pure gold) in security. In this case, where the trustees pay the debt and collect the gold, this would not be redemption. The trustees represent the debtor (Ato Gebre) and not the third party who produced his property in security.

When do you think that the commissioner can authorize the trustees to pay and redeem the movable produced in the form of security? Normally, the commissioner cannot come to the decision that the movable should be collected and join the bankrupt estate. There should be a good reason to come to such conclusion. Actually, the law has not come up with specific and express grounds for such a position. It has provided a subjective standard on which the commissioner has discretion. It is where such decision is found to be in the benefit of the bankrupt estate. When the redemption becomes in the benefit of the bankrupt estate or otherwise is left to the determination of the commissioner. In the normal course of things, it is expected of the commissioner to decide having regard to the standard of a reasonable person.

## **II) Right to sale**

The trustees, as we have discussed earlier, may not always pay and redeem the movable property in the hands of the creditor. It is only where such redemption is found to be in the benefit of the bankrupt estate. It then follows that where the redemption is found not to be in the benefit of the bankrupt estate, the creditor remains to be possessor of the security. The question then remains as to what happens to the rights of the creditor. In order to address this issue, now read the provisions of Article 1059 of the Commercial Code.

*Art. 1059- Sale by pledgee*

Where the property pledged has not been redeemed by the trustees, and it is sold by the pledgee for a sum exceeding the amount of the debt, the excess shall be collected by the trustees. Where the price of sale is less than the amount of the debt, the pledgee may prove his claim for the difference, as an unsecured creditor.

The creditor has the right to sell the movable property in cases where the trustees failed to pay and redeem it. This clearly indicates that the creditor's right to sell the pledge is dependent on the condition that the trustees defaulted in paying and redeeming it. As you remember from your study of the Law of Sales and Security Devices, failure of the debtor to discharge the principal debt does not automatically entitle the pledgee to sell it. It is also the rule of the law that the pledgee shall not become the owner of the pledge where the debtor has failed to pay the principal obligation. Similarly, in the case of bankruptcy, the creditor whose claim is secured by movable could not become the owner of the property as a result of bankruptcy of the pledger. He can also not automatically sell the movable on adjudication of bankruptcy of the pledger. If he is to sell it, he has to wait for the decision of the trustees.

Where the creditor has sold the movable, because the trustees did not pay and redeem, the price could be either more than the debt secured by the movable or less than it. It could not be concluded that the creditor always takes possession of movables that the values of which are equivalent to the debts secured. Sometimes, the movable could have more value than the debt it secures and in other times could have a value less than the debt. Apart from that, there could be situations of market fluctuation in the value of the property. The important issue to be discussed is as to what happens in case where the creditor sold for a value different than the debt secured.

Where the creditor has sold the movable property for a value which is equal to the debt secured, there would be no problem. The creditor gets what he claims from the bankrupt person and his claim would be settled thereby. But in cases where the property is sold for

a value more than the debt secured, the trustees are to collect the difference on behalf of the bankrupt estate. For example, assume that Ato Mesfin is the bankrupt person. Before his adjudication, Ato Mesfin produced his movable property to secure the debt he owes to W/ro Gebeyanesh. The debt Ato Mesfin owes to W/ro Gebeyanesh was 12,000 Birr. The movable produced in the form of security was one kilogram of gold. After adjudication of the bankruptcy of Ato Mesfin, the trustees failed to pay and redeem the gold from W/ro Gebeyanesh. As a result, she sold the gold for a price of 25,000 Birr. In this case, since her claim against the bankrupt debtor is only 12,000 Birr, W/ro Gebeyanesh should collect only that amount and let the trustees collect the remaining 13,000 Birr. If that amount is left in the hands of W/ro Gebeyanesh, that paves a way to her unlawful enrichment. It seems logical and justifiable that the trustees collect the difference. The creditor should not be unlawfully enriched under the guise of bankruptcy of the pledger.

### **III) Prove for the difference**

In the preceding paragraphs, we have discussed that the excess has to be collected by the trustees in case the movable is sold for a value more than the debt secured. In case where the movable is sold for a value less than the debt secured, what happens to the right of the creditor? Did you answer “He should prove for the difference”? If you answered so, that is great. As the sub title under discussion reveals, the creditor is to exercise his right of proving for the difference. For example, assume that Ato Damene is the bankrupt person. Ato Moges was his creditor to the extent of 20,000 Birr. A movable property belonging to Ato Damene was produced to secure the 20,000 Birr debt he owes to Ato Moges. During the bankruptcy proceedings, because the trustees failed to pay and redeem the movable property, Ato Moges sold the movable. He sold it for a price of only 12,000 Birr. In this case, there is a difference of 8,000 Birr between the value of sale and the debt secured. For this difference, Ato Moges has the right to prove in the bankrupt estate.

Do you think that the creditor still holds his secured position while he participates in the bankruptcy? I am sure that you answered “No”. If your answer is so, you are correct. As per the rules of the Law of Insurance, the insured, who has undervalued his property shall

be considered as his own insurer as regards the difference in case the risk materializes. But in the case of bankruptcy, the creditor who collected a value less than the debt secured is not to be considered as his own guarantor. Rather he participates in the distribution along with the unsecured creditors. In other words, he would not retain his position of secured creditor as regards the difference between the value he collected and the debt secured by the movable. As a result, he would get proportionate distribution of the proceeds of sale of the available properties of the bankrupt person. There is no way for him to claim to have prior right to get payment. Had he got a property the value of which is either equal or more than the debt secured, he would have got full payment of his claim. But where the price is less, there is higher probability that such creditor would get less than the debt secured.

#### **IV) Enjoy preference**

As we have discussed earlier, the commissioner is responsible to pass the list of creditors claiming preference over the movables of the bankrupt person. The preference right may arise from several relations with the bankrupt person. As per the provisions of Article 1064 of the Commercial Code, the commissioner may authorize such creditors to get prior payment from the funds first collected. As they are claiming preference over the movables of the bankrupt person, they are not to be treated equally with the other unsecured creditors. This is when the commissioner thinks it appropriate. Where there is objection or dissatisfaction with the preference, it shall be decided by the court.

#### **5.3.2. Rights of Creditors Secured by Immovable**

As we have discussed earlier, the bankrupt person may produce an immovable to secure his debt. As you remember from your study of the Law of Security Devices, the contract by which a person secures a debt he owes others by producing an immovable property is called mortgage. Where it is the bankrupt person who produced the immovable as security, he becomes the mortgagor and the creditor whose claim is secured by the same

immovable is the mortgagee. In this section we are going to briefly discuss the rights of a creditor whose claim is secured by immovable.

As discussed earlier, where the claims of a creditor is secured by movable properties, the trustees can at any time pay and redeem the property. Otherwise, the creditor can sell the property. Where the claim of the creditor is secured by an immovable, it would not be similar to that of the case of security by movables. In the case of mortgage, as you know, the mortgagor is not under obligation to transfer possession of the immovable mortgaged. As opposed to the case of pledge, the right of possession over the immovable remains with the mortgagor. It is only the document of title of the immovable that could be handed over to the mortgagee. As a result, there will be no instance of redeeming since the immovable is under possession and ownership of the mortgagor. It is also not possible for the mortgagee to sell the immovable since the ownership and possession of the immovable remains with the mortgagor.

As the immovable remains in the hands of the mortgagor, in case where the mortgagor is a person who is declared bankrupt, the immovable forms part of the bankrupt estate to be administered by the trustees. During the bankruptcy proceedings, the trustees are to sell the immovable properties of the bankrupt person, including those produced in the form of security.

What do you think happens if the creditor's claim is not satisfied by the proceeds of sale of the immovable? In order to answer this question, now read the provisions of Article 1065 of the Commercial Code:

*Art. 1065- Sale price of immovables distributed before that of movables*

Where the distribution of the proceeds of sale of immovables takes place before or at the same time as that of the proceeds of sale of movables, preferred or secured creditors not fully paid out of the proceeds of sale of the immovables shall (provided their debts were admitted to proof in accordance with the provisions of Art. 1041 et sq.)

rank equally with the unsecured creditors for the amounts still due to them in respect of the residue of the estate.

As per this Article, in case where the creditor, whose claim is secured by immovable, has not satisfied his claim from the proceeds of sale of immovable properties, he can participate in the distribution of proceeds of sale of movable properties. The movable properties could be sold and the proceeds distributed either before the immovable properties or simultaneously. In other cases, both categories of properties may be sold one after the other. It is within the discretion of the commissioner as to which property should be sold when. Where the immovable properties are sold later than the movables, there is no way that the creditor whose claim is secured by immovable can participate in the distribution of the proceeds of such sale. Since it is not yet known that the creditor would satisfy his claims from the sale of immovables, he cannot participate in the distribution of proceeds of sale of movable properties. But where the sale of immovable properties takes place before the movable or simultaneously, there is a possibility to participate in the distribution of proceeds of sale of movable properties. The fact that the proceeds of sale of immovable properties would not satisfy the claims of the creditor could be known promptly in such cases.

Have you noted that it is not all the creditors whose claim is secured by immovable who can so participate? If so, that is great. It is only creditors whose claim is secured by immovables and the proof of which is accepted by the trustees during the process of proving debts. Where there is query or rejection of the proofs, a creditor, even if he claims that his debt is secured by immovable, is not entitled to participate in the distribution of proceeds of sale of movable properties. Apart from this, it is only creditors who are not fully paid from the distribution of the proceeds of sale of immovable who can participate. Where the claims of a creditor are fully satisfied from the proceeds of sale of the immovables, therefore, no right to such creditor to participate in the distributions of proceeds of sale of movables remains.

Do you think that the creditor would lose his position of secured creditor for the unsatisfied claim? Did you answer “No”? If you answered so, you are not correct. As we discussed in relation to the rights of creditors secured by movables, the creditor secured by immovable will also lose his position of secured creditor. When he participates in the distribution of the proceeds of sale of the movables, the creditor is to participate equally with the unsecured creditors. As a result, his entitlement would be for proportionate distribution of proceeds of realization of available assets of the debtor. In other words, he cannot claim full payment of the unsatisfied amount as if he were secured creditor. The assumption is that for the unsatisfied amount, he becomes his own guarantor by taking his share along with the ordinary creditors of the bankrupt person.

In cases where the sale of movables takes place before the immovable and distributions of proceeds of such sale are made, the creditors who are secured or preferred can participate in such distributions. However, it has to be noted that the claims, preference, and security of the creditors is admitted and duly accepted by the trustees during the process of proving debts. Note also that this participation is not mandatory. It is permissive in that the law does not require such creditors necessarily to participate. The extent of claim for which such creditors participate could go up to the whole claim they have against the bankrupt person. Read Article 1066 of the Commercial Code:

*Art. 1066- Proceeds of sale of movables distributed before that of immovables*

Where one or more distributions of the proceeds of sale of movables takes place before the distribution of the proceeds of sale of immovables, preferred and secured creditors duly admitted to proof may participate in such distributions in proportion to the whole of their debts, subject otherwise to the appropriations set forth in Art. 1067.

What if the secured creditors have collected a certain amount of their claim from the estate not subject to security? For instance, the secured creditors may collect a certain amount from the liquid cash of the debtor in his bank account or in his hands on the date of adjudication of bankruptcy. In such cases, the proceeds of sale of immovable would be

paid to such creditor after the previous payments are deducted. For example, assume that Ato Bedilu is the bankrupt person. He produced a certain immovable to secure the (20,000 Birr) debt he owes W/ro Halima. During the bankruptcy proceedings, the trustees sold the immovable of the bankrupt person and distributed the proceeds. W/ro Halima collected 5,000 birr from the unsecured properties of the debtor. The immovable was sold for a value of 23,000 Birr. In this case, the proceeds of sale of the immovable would be paid to W/ro Halima by deducting the 5,000 Birr she collected previously. As a consequence, she would be entitled for payment of only 15,000 Birr from the proceeds of sale of the immovable.

What part should the amount deducted form? As per the provisions of Article 1067(2) of the Commercial Code, the amount deducted from the proceeds of the sale of immovables shall not form part of the secured bankrupt estate. It should form part of the estate not secured. It seems logical to make it form part of the unsecured estate, which is to be used for satisfaction of claims of the unsecured creditors. As it was paid from the unsecured estates of the debtor, the deducted amount should come back to that part of the estate.

The principles, as regards creditors whose claim is secured by mortgage on the business of the bankrupt person, are similar to those secured by immovables. Alike the creditors secured by immovables, those whose claim is secured by mortgage on the business can participate in the distribution of proceeds of sale of movables. You can read the provisions of Articles 1069 – 1072 in light of the provisions of Article 1066 – 1068 of the Commercial Code.

#### **5.4. Recovery**

Under the section on the cardinal principles of bankruptcy, one of the principles we discussed is in relation to the properties subject to realization. As per this principle, it is only the properties on which the bankrupt person has interest that are to be attached and realized. All the properties which do not belong to the bankrupt person would not be sold for the satisfaction of claims of the creditors. Such properties have to be given to their

real owner. There should not be a situation where the owner suffers due to the bankruptcy of the possessor of his property. That is what we mean by the concept of recovery. In its most extensive sense, recovery refers to the restoration or vindication of a right existing in a person, by the formal judgment or decree of a competent court, at his instance and suit, or the obtaining, by such judgment, of some right or property which has been taken or withheld from him. We are going to discuss it briefly in this section.

The important issue to be raised in relation to recovery is which properties are subject to recovery. As far as the law is concerned, it provides that the negotiable instruments or securities, goods deposited, goods the sale of which is cancelled before adjudication of bankruptcy, goods sold with the ownership right reserved, and goods in transit can be recovered. Now let us discuss the rules of the law as regards recovery of each of these items in the following paragraphs.

#### **A) Negotiable instruments or securities**

Possibly, the real owner of a certain negotiable instrument may handover the same to the bankrupt person. The negotiable instrument could be handed over either in the form of bailment or for the purpose of collecting the value of the instrument on behalf of the real owner. In such cases, the real owner could succeed in claiming recovery of the instrument. Now let us read the provisions of the Commercial Code regulating recovery of negotiable instruments or other securities:

##### *Art. 1073- Recovery of negotiable instruments*

Negotiable instruments or other securities which have been handed to the debtor for purposes of collection for the benefit of the owner and which, not having been collected, are in possession of the debtor at the time of adjudication of bankruptcy may be claimed by the owner. The same shall apply to remittances specially made by the owner to be appropriated to specified payments.

As you can understand from the above cited provision, the negotiable instrument has to be handed to the bankrupt person before the date of his adjudication. In other words, the provision does not regulate recovery of negotiable instruments handed after the debtor is already declared bankrupt. The instrument has to be handed only for the purpose of collecting its value on behalf of the real owner. As it is handed just for the purpose of collecting the value, the right of ownership remains with the one who handed the instrument to the bankrupt person. As a result, the trustees could not succeed in claiming that the negotiable instrument forms part of the bankrupt estate. The mere reason that the negotiable instrument was found in the hands of the bankrupt person on the date of his adjudication does not make it to form part of the bankrupt estate. For example, assume that Ato Nigusse is declared bankrupt on September 5, 2004. Two months before the adjudication of bankruptcy of Ato Nigusse, W/ro Rahel handed over a cheque with a face value of 76,000 Birr. She handed over the cheque for collection because her place of residence is very far away from the place of the drawee bank. As Ato Nigusse resides near the drawee bank, Rahel assigned him to collect the value and transfer the money to the bank in her place. Unfortunately, Ato Nigusse was declared bankrupt and the cheque was still in the hands of him. In this case, W/ro Rahel could succeed in claiming recovery of the same cheque. Not here that the negotiable instrument is to be treated like any property that has physical existence.

What do you think would happen if the value of the negotiable instrument is already collected by the bankrupt person? You see the right of recovery applies only where the negotiable instrument is in the hands of the bankrupt person. Where it is transferred to another person for value, the real owner could not succeed in claiming to recover it. In other words, the right to recover is to be implemented only where the thing to be recovered has not changed hands. Once the value of the instrument is collected, it is converted into liquid cash which forms part of the bankrupt estate. As a result, the real owner could not succeed in claiming recovery. As we discussed earlier, the assumption is that a person who is declared bankrupt could not pay money debts as of the date of his adjudication.

Where the thing handed to the bankrupt person is a security other than negotiable instruments, the same principle applies. Do you know what securities are? I hope you remember what securities are. They are documents representing a right and which can be transferred from one hand to another and produced in the form of security. It could be share certificate, debenture, life insurance policy, and the like. So long as the security is not transferred to another person for value, the owner of the security can recover it if the person to whom it is transferred is adjudicated bankrupt. For instance, Ato Yilma is declared bankrupt. Before he is declared bankrupt, W/ro Damenech handed over her share certificate with the view of depositing it with Ato Yilma. Unfortunately, Ato Yilma transferred the share certificate to Ato Abdi for value. In this case, W/ro Damenech could not recover her share certificate as it is already transferred to another person. Neither could she recover the value collected by Ato Yilma because it forms part of the estate that is to be distributed among creditors proportionally.

What if what is given to the bankrupt person is money for the purpose of making payments on behalf of the one who gave it? As we have discussed earlier, in principle, the bankrupt person is not expected to discharge money debts as of the date of his adjudication. Where a certain amount of money is given to him for the purpose of making payments on behalf of another person, the one who gave the money can claim recovery of the same money. For example, assume that Ato Worku is declared bankrupt on July 3, 2005. A week before his declaration of bankruptcy, W/ro Simenesh gave 5,000 Birr to Ato Worku. The money was given for payment of the tax which W/ro Simenesh owes the Tax Authority. Ato Worku also received the money just to pay to the Tax Authority. Unfortunately, Worku was declared bankrupt before he pays the money to the said Authority on behalf of W/ro Simenesh. In this case, the latter can recover the money. The idea here seems that the bankrupt person was the agent of the real owner of the remittance made and as an agent he could not acquire the properties of the principal.

## **B) Goods deposited**

In the previous sub-section we have discussed the case where the bankrupt person is in possession of negotiable instruments or other securities belonging to another person. In this sub-section, we are going to discuss the case in which the bankrupt person is in possession of other goods, on the date of his adjudication, belonging to another person. Now read the provisions of the Commercial Code regulating the recovery of such goods.

*Art. 1074- Recovery of goods in deposit or handed to an agent*

- (1) Goods consigned to the debtor for deposit or for sale on behalf of the owner may, if they exist in kind, in whole or in part, be recovered from the debtor.
- (2) The price or part of the price of the said goods may furthermore be recovered, where it has not been paid in cash, nor settled for value given, nor set off in current account between the debtor and the purchaser.

As the bankrupt person is free to enter into different kinds of transactions before he is adjudged bankrupt, sometimes he may receive goods belonging to another person. The goods could be received just for the purpose of deposit in cases where the bankrupt person is a bailee or a warehouse owner. In other cases, the goods could be received for the purpose of sale on behalf of the real owner. For example, assume that Ato Mogese is government employee who has no knowledge about the current market and other matters related to sale of a car. He wanted to sell his car. Because he has better knowledge on matters related to car, Ato Kifle took delivery of the car of Moges. The car was delivered with the view that Ato Kifle would sell it on behalf of Moges. Unfortunately, Moges was declared bankrupt before he sells the said car. In this case, Mogese can succeed in claiming recovery of the car from Kifle.

What if the goods deposited with the debtor do not exist? Did you answer saying “The owner would not succeed in claiming recovery”? If you answered so, you are correct. It is

only where the goods exist in kind in the hands of the bankrupt person that the real owner can succeed in claiming recovery. In other words, where the goods are already sold as was intended by the real owner, no way to recover the goods. In cases where the goods are deposited because the bankrupt person is a warehouse owner or bailee, if the goods do not exist in kind on the date of his adjudication, there would be no possibility to recover those goods. The real owner could not compel the trustee to bring back the goods deposited. Where only part of the goods physically exist in the hands of the bankrupt person, the real owner can claim recovery of the existing part.

What do you think happens in case the goods are sold? In such cases, it all depends whether the debtor has already recovered the cash price or other value. In cases where the bankrupt person has already recovered the cash price of the goods, there would be no way for the real owner to succeed in claiming recovery of the price. The assumption here is that the goods are converted into liquid cash that forms part of the bankrupt estate. As a person who is adjudged bankrupt could not discharge money debts, the real owner is to stand along with the other creditors of the former.

The same is true in cases where there is an agreement to the effect that the debtor would settle his former debt by giving the goods he received for deposit or sale on behalf of the real owner. For instance, assume that Ato Mustapha is declared bankrupt. Before his adjudication, he received a good belonging to W/ro Azalech. The good was delivered for the purpose of sale on behalf of W/ro Azalech. Ato Mustapha agreed to sell the good to Ato Belay. Instead of cash price, Ato Belay agreed to settle the price by a debt which Ato Mustapha owes him. In this case, W/ro Azalech could not succeed in claiming the whole or part of the price of the good she deposited with Ato Mustapha. The only opportunity to W/ro Azalech is to stand along with the other unsecured creditors for the proportional distribution of the available resources of the bankrupt person. The same effect follows in case where the value of the good is set-off between the buyer and the bankrupt person.

In some cases, the buyer may partly pay the price in kind and the remaining in cash. Where the price is paid only in part and some amount remains with the buyer, the real owner can claim to recover that remaining amount.

### **C) Goods the sale of which is cancelled**

Do you remember what the effect of cancellation of a contract is? I hope you remember from your background knowledge of the Law of Contracts. As per the provisions of Article 1815 and the following, where a contract is cancelled the parties to it shall, as far as possible, be reinstated to the position they held before the conclusion of the contract.

Where a contract for the sale of goods has been concluded between the bankrupt person and another person, there may be instances where the seller could claim recovery of the goods sold. This will take place where the contract of sale is cancelled before the date of adjudication of bankruptcy of the debtor. The contract could be cancelled either because of court order or because of the terms in the contract. Where the sale contract, in which the bankrupt person is the buyer, is cancelled, the seller of the goods can succeed in claiming recovery of the goods. Note, however, that the seller can succeed in recovering the goods only if they physically exist on the date of adjudication of bankruptcy. Now read Article 1075 of the Commercial Code:

*Art. 1075- Recovery of goods the sale of which has been cancelled before bankruptcy*

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

What do you think is the rationale behind recovery of the goods where the contract is cancelled? As we have discussed earlier, the effect of cancellation of contract is reinstatement of the parties to their previous position. In the case of contract of sale, where the contract is cancelled, the seller is to take back the goods sold and the buyer is to get back the price he paid. As it is the bankrupt person who is the buyer of the goods, the seller can claim recovery of the goods where the contract is cancelled. Therefore, the recovery is as a result of the cancellation which results in reinstatement of the parties. The one who can claim recovery is the one who sold the goods. He can, therefore, get back the goods as an effect of cancellation of the contract.

#### **D) Goods sold with the ownership right reserved**

One of the basic obligations of the seller under Sales Law is to transfer unassailable right to the buyer. Though this is the principle, in some cases, the seller may not transfer the right of ownership on the date of conclusion of the contract of sale. As far as the rules of sales law are concerned, it is permitted that the seller retains the right of ownership for a certain period of time. The provisions of Article 2387-2389 of the Civil Code regulate contracts of sale with the right of ownership reserved.

In cases where the seller of a certain good has transferred only the right of possession of the goods, reserving the right of ownership, the same person can claim recovery of the goods. In such cases, the bankrupt person is the buyer, who did not get the right of ownership over the good sold. Where the right of ownership is with the seller, the good could not form part of the bankrupt estate. The seller still remains the owner of the good and, therefore, could claim recovery of the good, if it exists in kind. The trustees could not refuse to give the good bought with the right of ownership reserved. The right of recovery, however, could be enjoyed only where the fact that the right of ownership reserved is registered.

## **E) Goods in transit**

As we have discussed earlier, the bankrupt person could enter into several transactions. Accordingly, the debtor could conclude a contract to the effect that a certain good transfers to him through a third party. The third party's role would be to transfer the goods being a transporting agent. Where there is such an agreement and the adjudication of bankruptcy of the debtor is declared before the goods reach to the bankrupt person, the person who sent the goods through the transporter can recover the goods. Now read the provisions of the Commercial Code, which regulate the recovery of goods in transit:

### *Art. 1077- Recovery of goods in transit*

- (1) Possession of goods transmitted to the debtor may be recovered where such goods have not been delivered to the debtor's warehouse or to that of an agent entrusted with their sale on the debtor's behalf.
- (2) Recovery is not admissible where, prior to their arrival, the goods have been sold with no intent to defraud to a transferee in good faith on the basis of documents signed by the consignor.

As you can understand from the above cited provision, whether the person who claims recovery has already got payment on the goods or not, he can claim to get recovery of possession of the goods transmitted to the bankrupt person. Note here that it is only possession of the goods that is to be recovered, but not the ownership. The idea here seems that the ownership over the goods transmitted is with the bankrupt person as of the date of agreement for sale or otherwise. The right of recovery could be enjoyed only before the goods fall into the possession of the bankrupt person or another person on his behalf. For example, assume that Ato Adane is declared bankrupt. As per previously made contract, Ato Bekele sent certain goods through a transport agent operating in their place. On the date of adjudication of bankruptcy of Ato Adane, the goods were already deposited in the warehouse where Ato Adane usually deposits his goods. In this case, Ato Bekele could not succeed in claiming recovery of possession of the goods he has already

transmitted because they are already deposited in the warehouse of the bankrupt person. The same would have been true had the goods fallen in the hands of an agent appointed by the bankrupt person for the purpose of selling the goods transmitted.

Do you think that the right to recovery is mandatory? I am sure your answer will be "No". If you answered so, that is great. As the readings of Article 1077(1) clearly reveal, the right to recovery of possession of goods transmitted is not mandatory. It could be enjoyed only where the person who has transmitted the goods is taking initiative to claim recovery of the goods. Otherwise, where he is not interested to claim recovery, the law does not make it mandatory and, therefore, the person could not be compelled to claim recovery.

There might be instances where the bankrupt person sells the goods transmitted while they are in transit. As you know, it is possible to sell goods in transit, even if they are not actually possessed by the person to whom they are transmitted. The one to whom the goods are transmitted can sell them and transfer the right of ownership simply by transferring the documents of title- namely the bill of lading. Accordingly, where the bankrupt person has sold the goods in transit, the person who sent them cannot claim recovery of possession of the goods. There is no direct legal relationship between the consigner and the third party who bought the goods in transit. For instance, assume that Ato Dinberu has ordered goods from one foreign company. According to the order, the foreign company consigned the goods and was waiting for the price of goods to come through the advising local bank in his country. After coming to know that the goods are on board, Ato Dinberu concluded a contract for the sale of such goods with W/ro Sadiya. He got payment of the price on the spot and transferred the bill of lading to W/ro Sadiya. A week after the goods are consigned, the foreign company came to know that Ato Dinberu is declared bankrupt. As a result, he wanted to recover the goods in transit. In this case, the foreign company could not succeed in recovering the goods. This is mainly because the ownership over the goods is transferred to W/ro Sadiya and there is no direct legal relationship between the buyer and the foreign company.

Note, however, that the good faith of the bankrupt person counts. Where the bankrupt person sold the goods in transit with the intention to defraud, the sale would not be legally valid and as a result the person who transmitted the goods can claim and succeed in recovering the possession of the goods. Not only the good faith of the bankrupt, but also that of the transferee is important. The one who buys the goods should also be in good faith. Where the buyer bought the goods knowing that the debtor is declared bankrupt and the sale is made just with the view of defrauding, there is no way for a valid title to transfer to the later buyer. Therefore, recovery would not be admissible. There is in fact another requirement that has to be fulfilled. There should be consent of the consignor to the effect that the goods are sold to the later buyer before they arrive to the bankrupt person. It seems here logical that the consignor loses the right to recovery because it is as a result of his consent that the goods are sold before they arrive to the warehouse of the bankrupt person. While it was he who signed a document to the effect of sale of the goods, he should not be again given the right to recover possession of the goods in transit.

In the preceding sub-sections, we have been discussing the circumstances in which a person entitled can claim recovery of his property from the hands of the bankrupt person after his bankruptcy is already adjudicated. These circumstances have taken into account the fact that the goods are in the hands of the bankrupt person. In other words, it is where the one who can claim recovery is not in possession of the property. But sometimes, it may happen that the bankrupt person, though he has acquired the right of ownership, is not in possession of the property.

What do you think would happen if the seller has not yet delivered to the buyer the goods he sold based on a contract? In order to answer this question, now read the following provisions from the Commercial Code:

*Art. 1078- Right of retention*

The seller shall be entitled to retain goods sold by him where such goods have not been delivered to the debtor or they have not been consigned either to him or to a third person on his behalf.

I hope you answered the question properly. As per the above-cited provision, where the goods sold are in the hands of the seller, he can retain them. Though the right of ownership is transferred by contract to the bankrupt person, because of his adjudication of bankruptcy, he can retain the goods sold. In such cases, there is no issue of recovery since the goods are already in the hands of the seller. He could not recover from himself. Rather, what he entitled to do is to retain the goods until the trustees demand delivery. The same would be true where the goods have not been consigned to the bankrupt person or his agent appointed to take delivery on his behalf.

How do you think the trustees demand delivery of the goods already sold but not delivered to the bankrupt person? Did you try to answer this question? If so, that is great. You see, the provisions of Article 1079 of the Commercial Code regulate the rights of the trustee. As per this Article, the trustees can demand delivery where they have paid the agreed price. The idea here seems that since the bankrupt person has already acquired the right of ownership at the time of conclusion of the contract of sale, there is nothing to prevent the trustees to claim possession of the goods. The obligation of payment of the price is one of the important duties of the buyer and where the trustees discharge such obligation, nothing prevents them to demand delivery. As of the time of contract, the goods form part of the bankrupt estate. It is one of the duties of the trustees to collect the properties forming part of the bankrupt estate and administer them. In order to demand delivery, however, the trustees should get permission from the commissioner. Here it seems that the commissioner can take into account the advantage of taking delivery of the goods already sold as compared to the price to be paid. If it is disadvantageous to the estate, the commissioner would not give permission to demand delivery. But where the good sold is in a good condition and will benefit the estate, the commissioner would order the trustees to demand delivery on payment of the agreed price.

What happens if the trustees fail to demand delivery of the goods? As we have discussed earlier, the trustees may fail to exercise the right to demand delivery of the goods where the commissioner finds it disadvantageous to the estate. In such case, the law has a solution under the provisions of Article 1079(2). As per this sub-article, the seller is to be compelled to repay any payments he has taken in advance. Installment payment, advance payment, payment of insurance or transporting, etc received by the seller shall be returned to the bankrupt estate. However, this does not mean that the seller is not entitled to compensation. He can claim compensation to be paid, which he incurred due to the non-performance of the contract as agreed.

## **CHAPTER SUMMARY**

In this unit we have been discussing that a person could not be simply considered as creditor of the bankrupt person unless he proves to that effect. There are procedures to be followed in order to accomplish the task of proof. It is the trustees who are to receive proof of the creditors. There are rights that could not be proved and proof refers to documents that can ascertain the fact that a person is the creditor of the bankrupt person.

Where the claims of the creditor are secured by the bankrupt person and other persons who stand as guarantor, the creditor can prove in the bankruptcy of both the principal debtor and the guarantor, in case the guarantor has already suspended payments. But where the guarantor has not suspended payments, the creditor can claim from him and where he gets payment, such amount is to be deducted from the claims he has towards the bankrupt person.

We have also discussed the rights of persons secured by movable or immovable properties of the bankrupt person. Where a creditor is secured by movable property belonging to the bankrupt person, he could not automatically get entitlement to sell the pledged property. It is only where the trustees fail to redeem that the trustee can sell the pledge. In case it is the pledgee who sold the pledge, he has to deposit the excess amount

with the estate. But where the value for which the pledge is sold is less than his claim, for the difference, he stands along with the other unsecured creditors. Creditors, whose claim is secured by immovable or the business of the bankrupt person, can participate in the distribution of proceeds of sale of movable properties, if they could not satisfy their claim from the proceeds of sale of the immovable or the business.

As per the principle of attachment of only the properties belonging to the bankrupt person, the real owner of a property can claim recovery of his properties. In order to exercise the right of recovery, the property to be recovered has to exist in kind in the hands of the bankrupt person on the date of his adjudication. Where the property has changed hand, in principle, the real owner could not succeed in claiming its recovery. The properties could be either corporeal or incorporeal like negotiable instruments or securities.

## **REVIEW QUESTIONS**

1. List down the steps to be taken in proving debts.
2. Discuss the duties and responsibilities of the persons in charge of the proof.
3. Which category of creditors is to produce proofs? In other words, is it the secured, preferred or unsecured creditor?
4. While bankruptcy person was present at the time of verification of debts and the inventory is prepared later, why is it allowed that he lodge claim?
5. Can the joint debtor, who paid, get payment irrespective of his share in the joint debt? Why or why not?
6. In the case of contract of pledge the pledge, has no ownership right over the movable produced in the form of security. He has only right of possession. One of the obligations of a seller is to transfer an unassailable right. How can the right of ownership be transferred to the buyer, in case whether he sells the movable secured?

## **CHAPTER SIX**

### **SETTLING THE BANKRUPTCY**

In the preceding chapter, some general points related to proof of debts has been made. In this chapter, we will see settlement of bankruptcy proceeding. There are essentially two forms of settlement: composition and compulsory winding up. The bankruptcy proceeding may also be closed either for insufficiency of assets or absence of any claim against the estate by the universality of creditors.

#### **Introduction**

As a result of the adjudication, the bankrupt may be ridiculed, lose the right to administer and dispose his properties, and his freedom of movement would be restricted, etc. Normally, the debtor is not expected to be willing to face these disadvantages. Nobody is, in the normal course of things, would accept these disadvantageous effects of the bankruptcy proceedings. As much as possible, the debtor is to minimize or totally avoid the disadvantageous effects of the bankruptcy proceedings.

In order to enable the bankrupt person minimize or totally avoid the bad effects of the bankruptcy proceedings, the law has devised certain mechanisms. One of those mechanisms is composition. The law has devised this as one of the mechanisms to settle the bankruptcy of the debtor. Where the composition is not successful, the law provides for compulsory winding up. This chapter discusses the mechanisms of the settlement of bankruptcy of the debtor.

The chapter is divided into three sections. The first section is on composition. It mainly focuses on the procedures to be followed to accomplish the composition arraignment. The second section is on compulsory winding up. This section discusses the procedures as regards sale of the properties of the bankrupt person and the distribution of proceeds of sale of the properties. The third section is on closure of the bankruptcy proceeding. Here, it lists the grounds for closure of the bankruptcy proceeding.

## **Objectives:**

Generally, at the end of this chapter, the student will be able to:

- Identify the two grounds that lead to the closing of bankruptcy proceedings;
- Spell out under what conditions composition will be allowed;
- Write the differences and similarities among composition, compulsory winding up, and closure of bankruptcy proceeding;
- Enumerate the effects of composition, compulsory winding up and closure of bankruptcy proceeding as regards the debtor and creditor;
- Explain plan for the distribution of the proceeds of the windings –up; the actual distribution of these proceeds and the measures taken to protect creditors whose rights have been contested; and
- Discuss how composition may be cancelled and set aside.

## **6.1 Composition**

### **6.1.1 Institutions and officers involved in compositions**

Before we discuss the substance of the proceedings involved in composition in detail, the frame work within which compositions are carried out should be explored so that we may gain a perspective of the institutions and officers involved in compositions. All the institutions and officers responsible for conducting bankruptcy proceedings are involved in compositions. They are the court, the commissioner, the trustees and the creditors' committee.

#### **6.1.1.1. Court**

The High court of the place the businesses of a trader is situated or, where there is more than one business, the place where the principal business is situated, has exclusive jurisdiction over bankruptcy proceeding. The High court supervises all bankruptcy

proceedings and makes orders on matters which are outside the powers of the commissioner. The granting or refusal of composition rests with the court which confirms a composition when it is not contrary to public interest or the interest of creditors.

#### **6.1.1.2 Commissioner**

There is no provision in the commercial code dealing with the appointment of commissioners. The replacement of commissioner is, however, provided in. Article 993 provides, “the court may at any time of its own motion replace a commissioner by another of its members.” This article clearly indicates that the commissioner is a judge. The French and Amharic versions of the commercial code also indicate that the commissioner is a judge. The equivalent phrase used are “Judge-commissaries”(judge-commissioner) and “mermari dagna” literally” “investigating judge” The commissioner has the power to supervise and deal with all matters concerning the bankrupt estate.

#### **6.1.1.3 Trustees**

Trustees are selected from a list of qualified persons prepared by the ministry of commerce and Industry. A bankrupt, or a person deprived of civil rights, a relative by affinity or consanguinity to the fourth degree inclusive or a creditor cannot be appointed as trustees. The trustees are responsible for the administration of the bankrupt estate under the supervision of the commissioner and they represent the universality of creditors in relations to third parties.

#### **6.1.1.4 Creditors’ Committee**

Three or five creditors are chosen by the commissioner to form the creditors’ committee. A relative by consanguinity or affinity of the debtor up to the fourth degree inclusive cannot be a member of the creditors’ committee. The creditors’ committee plays a role in the verification of the accounts and the statement of affairs prepared by the debtor and supervises the acts of trustees. The creditors’ committee has the right to require

information on the state of bankrupt or proceedings and on the position of receipts and payments. It is to be consulted with regard to all legal proceedings. The creditors' committee is a watch-dog of the interests of creditors. It is appointed because it is less cumbersome, more flexible and more effective than a creditors' meeting. It plays an important role before the confirmation of a composition by performing the functions described above. It also plays an important role after the confirmation of a composition since it may be instructed to supervise the carrying out of the composition in the judgment confirming compositions.

### **6.1.2 Definition of compositions**

A composition is a settlement of debts after a declaration of bankruptcy, between a debtor and his creditors upon payment of an agreed percentage of the total debts, subject to confirmation by a court. A settlement of debts may also be effected by a partial or total surrender of assets by a debtor in favor of his creditors. In other words composition is an agreement made upon a sufficient consideration, between an insolvent or embarrassed debtor and his creditors, whereby the latter, for the sake of immediate or sooner payment, agree to accept a payment less than the whole amount of their claims, to be distributed pro rata, in discharge and satisfaction of the whole debt. The bankrupt person is not normally willing to see the negative effects of the bankruptcy proceedings. The adjudication of bankruptcy has disadvantages to the debtor though it is advantageous in some aspects. The law has devised a mechanism by which the bankrupt person could minimize or totally avoid those negative effects. One of these mechanisms is composition.

### **6.1.3 The juridical Nature of composition**

#### **6.1.3.1 The object of a composition**

According to the prevalent opinion in Italy the object of a composition is the settlement of the debts of the bankrupt, which affects the respective patrimonial rights of the debtor

and the creditors. It is only as a consequence of the settlement of debts that the suspension of bankruptcy proceedings follows. Other Italian authors say that the object of a composition is the closure of bankruptcy proceedings. Third school of thought holds that composition is another form of liquidation.

According to the prevalent opinion in Italy, the arguments of the two latter schools of thought cannot be sustained. If a composition had as its object the closure of bankruptcy proceedings or was a special form of liquidation, its effects would be limited. Consequently, the creditors would still retain the right to recover the part of the debts which remained unpaid as it happens in the closure of bankruptcy proceedings. Following a composition, the creditors cannot demand more than the agreed percentage, and with the payment of such percentage their debts are considered satisfied. The consequence of affecting the rights of creditors which is obtained in compositions is not found in the closure of bankruptcy proceedings. This meant that the object of a composition cannot be represented by the closing of the bankruptcy proceedings.

The arguments of the prevalent opinion in Italy are not, I think, valid under Ethiopian law. Under Ethiopian law, compositions and compulsory winding up (which is followed by closure of bankruptcy proceeding) are treated under one chapter, viz., Book V. Title II chapter 6 settlement of Bankruptcy. They are the two sections of the same chapter. Thus, in the first form of settlement of bankruptcy, composition, the rights of creditors who are not fully paid does not survive while in the second form the rights of creditors who have not been fully paid scurvies. The debtors and the creditors are given a chance by the law to choose between two methods of settling bankruptcy. If the debtor proposes a composition, the creditors accept such proposals and the court confirms the composition, then the effects of bankruptcy are suspended and the creditors get only what they bargained for in the proposals of composition. If, however, the other choice is taken, either by the debtor not proposing a composition or the creditors rejecting the proposals or the court not confirming the composition, then the bankruptcy proceeding continues in its courses and the debtor remains liable until the claims of the creditors are fully satisfied. The argument of the prevalent opinion in Italy does not hold water, if we realize

that compositions and winding up followed by closure of bankruptcy proceedings are two different methods of settling bankruptcy intended to have different results.

In Ethiopia, composition may be seen as a special form of liquidation because composition may be effected through a partial or total surrender of assets. Again, if the debtor and creditors choose to settle the bankruptcy through a surrender of assets and when the court confirms such settlement, then the effects of bankruptcy are suspended. The reluctance of the prevalent opinion in Italy to look at compositions as a special form of liquidation may be explained by the fact that under Italian law composition by Surrender of assets is not allowed.

The object of a composition, as the argument goes, is the settlement of the debts of the unsecured creditors and the settlement of the debts is the object of the consent of the debtor and creditors. It is a settlement of debts outside bankruptcy proceedings for which the parties want the suspension of bankruptcy proceedings, not as an end in itself but as a means of realizing the settlement. I do not think that composition is a settlement of debts outside bankruptcy proceedings; it is in fact within the bankruptcy proceedings. All the institutions and the officers responsible for conducting bankruptcy proceedings are involved in composition. The proposals of the debtor do not go directly to creditors but is submitted to the commissioner who takes the advice of the trustees and the creditors' committee and has to be satisfied that the proposals have merit before he communicates them to the creditors. If the proposals are accepted by the creditors, it is submitted to the court for confirmation, even after confirmation, the commissioner, the trustees and the creditors' committee supervise the carrying out of the terms of the composition.

Since the suspension of the proceeding presupposes the removal of the insolvency, the argument continues, it is implicit that the terms of the composition be such as to enable the debtor to fulfill his new obligations; that is with regard to the percentage of the debts payable, the debtor should not be insolvent. Analyzing the intention of the parties, it is said, it can be seen that they want settlement of debts outside bankruptcy proceedings and therefore they want to suspend the bankruptcy proceedings, for the suspension of

bankruptcy proceedings, elimination of insolvency is necessary thus the parties reduce the obligations and /or improve the terms of payment to enable the debtor to fulfill his obligation .The solvency of the debtor with respect to his new obligations may be what obtains in fact in the case of composition. But the above argument does not answer the question why the debtor should be allowed a reduction of his obligation and suggest that the mere elimination of insolvency by a reduction of obligations justifies the suspension of bankruptcy proceedings. The mere elimination of insolvency does not, I think, justify the suspension of bankruptcy proceedings. For example, the debtor and his creditors may work out a plan that would enable the debtor to pay his debts but the court may refuse to confirm such a plan on the ground of Public interest. (Although the decision of the creditors to accept a proposal for composition is up to them, the court can refuse to confirm a composition in order to protect the interest of future creditors taking into account the past performance of the debtor.)In such a case composition cannot be obtained inspire of the agreement of the creditors and the actual solvency of the debtor with respect to his new reduced obligations. This shows that the settlement of debts is a means of obtaining a composition and thus suspension of bankruptcy proceedings. In other words, the settlement of debts is a pre-requisite for the suspension of the effects of bankruptcy.

The position of the prevalent opinion in Italy may be explained by the fact that in Italy the court does not consider whether the composition is contrary to public interest; the court only considers whether composition has been carried out in the prescribed procedure and whether the prescribed majorities have been obtained. The judgment confirming the composition is a judgment of pure ascertainment. It is different under Ethiopian law which only deserving debtors who fulfill prescribed conditions are granted compositions.

It can, therefore, be said that, under Ethiopian law, the object underlying composition, speaking strictly in terms of the obligations of the parties, is the settlement of debts. But speaking from the stand point of the policy of the law, the object is the suspension of the effects of bankruptcy which is a benefit to the debtor who is restored to the management

of his estate and is given chance to start afresh. This may also benefit the creditors because they may get something earlier than they would get if bankruptcy was carried to its conclusion.

### **6.1.3.2 Is a composition a contract or sentence?**

According to dominant opinion in Italy, the most important element in a composition is the agreement of the debtor and the creditors. According to another current opinion, it is the confirmation by the court that is the order of the judicial authorities. While the first school of thought does not deny the procedural elements to be found in compositions and only attributes to them a secondary position, the second school of thought sees composition as entirely a judicial disposition. The proposal by the debtor for a composition is considered an application which introduces the court into the picture, the agreement of the majority of creditors is a prerequisite for the measure to be taken by the court and is considered consultative in nature. Thus, everything would depend on the decision of the court; that is confirmation. I think that the agreement of the creditors (i.e. approval of the proposals of composition and confirmation by the court are complementary and inseparable, because in the absence of one of them composition is impossible. However, it can be said that confirmation by the court is more important because confirmation may be refused despite the fact that the proposal for composition are accepted by the creditors,

If the judicial disposition theory is to be maintained, the prevalent opinion in Italy says, a composition has to be considered as a power given to the judiciary to adversely affect the rights of creditors in order to suspend the effects of the bankruptcy. The power given to the judicial authority to sacrifice the private rights of creditors is contradictory to the institutional function of the courts in bankruptcy, which is in fact to safeguard and realize the interests of creditors. It is true that generally speaking the function of the courts in bankruptcy is to safeguard and realize the interests of creditor. But, in the case of compositions, the function of the court is not limited to the protection of creditors' interest. It has also importance to see to it that the deserving bankrupt debtor should be

given a chance to start afresh, provided that giving the bankrupt debtor such a chance is not contrary to the public interest.

Furthermore, the language use in composition provisions corresponds with those used in contracts. The 'proposal' of the debtor is 'notified' to the creditors who 'approve' or 'reject' the same. The prevalent opinion in Italy deduces from this that the law assumes the composition concluded before the decision of the court because the court is limited to 'confirming' compositions. This implies that the court is only involved in making sure that the composition is made according to the law. The same words are used in the provisions regulating compositions in Ethiopian law but the use of these word does not warrant the conclusion that a composition is a contract. One of the essential characteristics of contracts, freedom of contract, is absent in compositions because the court may effuse confirmation by saying that it is contrary to public interest. The completion of compositions is not left up to the will of the debtor and the creditors. Furthermore, even if a composition is not found to be contrary to public interest, the court may still refuse confirmation by saying that it is contrary to the creditor's interest, for example, where it considers the guarantees provided by the debtor insufficient. The proposals for composition are not directly offered to the creditors. They have first to be sent to the commissioner who take the advice of the trustees and the creditors' committees and notifies the proposal when he considers them to have merit. The court in confirming a composition does not only consider the votes of the creditors but has to take into account the report of the commissioner and his recommendation on the proposed composition, the recommendation of the trustees and the creditor committee. Finally, the court delivers judgment of confirmation. Thus, it can be said that composition is essentially judicial disposition.

The argument of the dominant opinion in Italy continues, since generally the duty of the bankruptcy court is the protection and realization of the creditors' interests, the exercise of the power of the court in extinguishing the private rights of some of the creditors without their consent cannot be explained by the theory of judicial disposition. It has already been stated that in the case of compositions to function of the court is not limited

to the protection of creditors interest. Secondly, the court does not extinguish the rights of some of the creditors without their consent. But, why a composition should be binding on those who opposed it. It is not unusual that the majority decision be binding on the minority. The point of contention is on what basis is the decision of the majority of creditors made binding on the minority. This cannot be explained by the fact that the creditors are constituted in a universality of creditors because the universality of creditors is created so that the estate of the debtor may be executed in concert and thus limited to the liquidation of assets. But the creditors have one common quality, which is the fact that the debtor has an obligation towards them. On the basis of this common quality or feature the law gives them the faculty to dispose of their rights on the basis of majority vote. The situation is similar to that of share holders in a company. They are grouped together on the basis of their common feature that is their ownership of shares and decide on the companies affairs by majority vote. Thus the law to resolve conflicts that may arise amongst the creditors has created an association of creditors and they resolve any conflicts among themselves by a majority vote. The gravity of this solution is tempered by requiring a high prescribed majority and introducing the control of the court through the judgment of confirmation.

I think proceedings in composition are in the nature of a judicial disposition. The law tries to strike a balance between the interest of society in saving the bankrupt debtor from the effects of bankruptcy and its interest in protecting the creditors' right to satisfaction in full. The creditors are given the right to decide (on the basis of majority vote) where to strike the balance between their rights and the rights of the debtor, since it is their rights that are immediately affected; but such a decision is final. The law gives the power to dispose of the matter to the court, not only by considering the immediate rights of the creditors but by taking into account the interest of the public at large. Thus, even an unanimous vote of the creditors although it may be highly persuasive, is not binding on the courting and its decision to confirm the composition. Since the final determination rests with the court the judicial disposition is more important.

#### **6.1.4 The initiation for composition**

Who can offer proposals for composition? Any person who has been declared bankrupt may submit a proposal of composition to the commissioner. The initiation for composition has to come from the bankrupt person. The law requires him to present a proposal to that effect. Otherwise, neither the court, the trustees nor the commissioner can initiate a composition.

There are no conditions for the admissibility of the proposal of composition such as that which obtains in the case of schemes of arrangement. A proposal for a composition by a bankrupt firm is made by its legal representative. In the case of general or limited partnership, the proposal and the term of the composition must be approved by the partners representing an absolute majority of the capital. In the case of share companies and private limited companies, proposals for a composition is approved by an extraordinary general meeting unless such approval is delegated to the directors.

#### **6.1.5 Time of proposal**

As to when and what conditions should be fulfilled, the law has regulated such issues under article 1081 of the Commercial Code of Ethiopia. The proposal for composition has to be made not any time, but after the expiry of the period specified under Article 1046 of the commercial code. This implies that one who can present a proposal for composition should be a person who has already been declared bankrupt. In other words, before his bankruptcy is declared and the creditors' present proof, no one can legally present a proposal for composition. Even if he presents, such proposal would not be valid because it is premature. As per Article 1046 of the Commercial Code, there is eight-day period within which a person who is not satisfied with the inventory of debts after proof could present claim to the court. The inventory of debt is to be prepared after the verification of debts is made in the presence of the bankrupt person. Therefore, the bankrupt person could not make a proposal for composition before the expiry of the eight days period within which a claim could be presented. Here the idea seems that if the proposal is

presented before the eight days period, the inventory of debts would not be final. The creditors who were rejected could be accepted after the claim is presented. In other words, this time limit has been set because by the time it expires most of the creditors would have proved their debts or lodged their claims. A proposal for composition cannot be accepted after the closure of the bankruptcy proceedings. This is for the obvious reason that suspension of the effects of bankruptcy by operation of law and is unnecessary in the closure of the bankruptcy. Where there is no further claim against the estate. The reason for the closure of bankruptcy proceedings is the insufficiency of assets, the universality of creditors are restored to their individual rights to claim from the debtor. Thus, there can be no composition. Proposals for composition can therefore, be submitted anytime before the bankruptcy proceedings are closed.

The composition is to be proposed as regards the creditors of the bankrupt person. As all the creditors are known because they have presented their proof, the composition is to be agreed up on by the creditors. It is a kind of negotiation between the bankrupt person and the creditors. The proposal has to be submitted to the commissioner.

#### **6.1.6 The contain of composition proposal**

The proposal for composition must contain:

- a) The percentage offered to the unsecured creditors;
- b) The period of time required for payment; and
- c) A description of the guarantees offered for the payment of debts, costs and remuneration of trustees.

First of all, the composition should clearly indicate the percentage offered to unsecured creditors. The percentage to be offered by the debtor is not prescribed by law. The composition has, however, to be in the interest of creditors. For the composition to be in the interest of creditors, the percentage offered has to be more than what the creditors would get through a liquidation of assets in bankruptcy or even if it is not more the creditors should get something earlier than what they would get through a liquidation in

bankruptcy. In short, it has to be seen that the creditors do not suffer any substantial prejudice in their rights. It is obvious that the decision that a proposal prejudices in their rights. It is obvious, that the decision that a proposal for composition will be in the interest of the creditors is necessarily approximate because the amount recoverable in liquidation of assets can be determined only hypothetically. Composition may also involve a total or partial surrender of assets and the court has to determine whether such surrender is in the interest of the creditors. The court is not likely to interfere on the basis of the percentage offered because it is up to the creditors to accept the percentage offered. If the debtor plans to pay eighty percent of the claim of each of the creditors, he has to indicate that in the proposal. Here what we have to note is that as far as the bankruptcy proceeding is concerned, the creditors are not expected to get hundred percent of their claim. As the debtor is declared bankrupt because his assets are less than his liability, none of the unsecured creditors could get hundred percent of this claim. In order to enable the creditors calculate their advantage in comparison with what they would get if the bankruptcy proceeding continues, the percentage is important. As regards secured creditors, the law does not bother because they have a certain property in their hands, either movable or immovable, belonging to the bankrupt person. Therefore, the percentage is to be offered for the unsecured creditors.

The second important thing to be included in the proposed composition is guarantee. The mere fact that the debtor has proposed to pay a certain percentage of the claim of each of the unsecured creditors could not suffice. There should be guarantee to the effect that the debtor would comply with the commitments. In the absence of assurance, the debtor may fail to comply with his commitments and then enter into dispute later. To avoid such a situation, the bankrupt person has to indicate the guarantee to the effect that he would discharge the payment of debts to the creditors, legal costs and the remuneration of the trustees. In the absence of sufficient guarantee to that effect, the proposal for composition would not be accepted. Guarantee makes greater sense here as the creditors deal with a bankrupt person. Guarantees be given by the debtor in respect of all his debts. It is not enough to indicate the guarantees offered, they have to be described in detail in order to enable the court to evaluate such guarantees. The guarantees may consist of any means of

assuring that the obligations of the debtor under the composition will be fulfilled, including pledge, mortgage and suretyship. The mortgage in favour of the creditors on the debtor's immovable property or on his business is not affected by the confirmation of the composition unless it is provided in the composition. Thus there is already some guarantee for the performance of the composition. The debtor may be required to furnish further guarantees where these are not considered adequate. The court may be stricter on the provision of guarantees because it has to make sure that whatever percentage agreed between the debtor and the creditor has to be paid.

The third thing to be contained in the proposal of composition is the time within which the proposed percentage is to be paid. The period of time required for payment is also not prescribed by law and the only provision again is that it has to be in the interest of the creditors. The period of time may be limited to one date or may allow payment installments. The period of time required for payment is fixed with respect to the unsecured creditors and does not apply to the payment of privileged creditors and the expenses of the procedure. If the bankrupt person plans to accomplish payment of the offered percentage within one year or six months period, this has to be clearly indicated in the proposal. It seems proper to fix the period within which the debtor could comply with the proposal. If it left open, the debtor would fail to discharge his commitment once he got the bankruptcy proceedings interrupted. If time is not indicated, it is like a contract with no definite time of performance, which is very difficult. In addition to that indicating the period would help the creditors decide to accept or reject the proposal by comparing it with the final outcome of the bankruptcy proceedings. If the proceeding could be accomplished within a short period of time and the proposed composition would take longer time, the creditors may opt for the bankruptcy proceeding.

### **6.1.7 Presenting the proposal to the creditor committee**

Assume that the proposal for the composition is presented to the commissioner fulfilling all the requirements. The next question is as to what is to be done by the commissioner. After receiving the proposal, what the commissioner shall do is to demand advice of the

trustees and the creditors' committee. The main reason why the law requires the commissioner to consult the trustees and the creditors' committee is to balance the interest of the creditors. The trustees represent the creditors because the universality of creditors is to be represented by them. The creditors' committee also stands for the interest of the creditors. Therefore, where the commissioner consults these bodies, the interest of the creditors is more protected. After consulting the trustees and the creditors' committee, the commissioner is responsible to notify the creditors that a proposal for composition is presented. However, he has to assure that the composition proposed has merit in it. There is no standard provided by the law. It seems left to the discretion of the commissioner. What is considered to be with merit could be taken as valid proposal and if the commissioner thinks that there is no merit, then the proposal is to be set aside before nothing is notified to the creditors.

Article 1082 (2) provides that, "where (the commissioner) considers the proposal has merit, he shall cause the creditors to be notified." Thus, a proposal for composition is subject to an examination by the commissioner who determines whether the proposal has merit. The commissioner can properly appraise the situation of the bankrupt's estate and the debtor's capacity to perform the obligations under a composition since he deals with the bankrupt's estate. Furthermore, he takes the advice of the trustees and the creditors' committee. A determination by the commissioner that the composition proposal does not merit consideration saves time by foreclosing the need to go through the procedures involved in compositions when the final result would be non-confirmation.

One can simply guess as to what could be considered in order to decide whether the proposed composition has merit in it or not. The yardstick could be the interest of the creditors. Where the commissioner finds that, on fulfillment of the composition, the creditors would benefit more than that of the bankruptcy proceedings, and then he could decide that the composition has merit in it. But where the commissioner finds that what is proposed, i.e. the percentage offered to unsecured creditors, the period of payment, and the guarantee produced is not satisfactory, the commissioner could say that there is no merit in it. For example, assume that the bankrupt person has proposed 75% of the claim

of each of the creditors to be paid within two years. He has produced guarantee which is not satisfactory. On the other hand the creditors are expecting payment of 85% of their claim. The bankruptcy proceeding could be accomplished within three months. In this case, it is not advantageous for the creditors if the composition is accepted. Therefore the commissioner has good reason to decide that the proposed composition has no merit in it.

A debtor may appeal to the court against a decision by the commissioner because any interested party may apply to set aside the orders of a commissioner. The court may affirm or reverse the commissioner's decision. However, even if the court affirms the decision of the commissioner, I think, it would not have the effect of barring the debtor from making another proposal taking into account the objections of the commissioner and the court. It is provided that a debtor can make a proposal at any time and there is no provision in the law which prohibits a debtor from making a second improved and more meritorious proposal for a composition.

If the commissioner considers the proposal has merit, he causes the creditors to be notified. Notification is made by the registrar of the court who sends each creditor a registered letter. If notifying the creditors is difficult or impractical, the court may order the proposal to publish in a newspaper empowered to publish legal notices. In doing so, the court has to hear the trustees and public prosecutors.

In addition to the proposals made by the bankrupt, the notification has to refer to the recommendation of the trustees and the creditors committee together with a report by the trustees showing the state of the bankruptcy proceedings and what has been completed. This all enables the creditors to decide whether to accept the proposed composition or not. The notification fixes a time limit of not less than twenty days and not more than thirty days within which the dissenting creditors may file with the registry their refusal to accept the proposed composition.

### **6.1.8 Voting**

The reasons why the creditors are to be notified is to enable them participate in the voting in favor or against the composition proposed. Which creditors are to vote; the secured or unsecured or both?

First of all it is only the creditors who are duly admitted that can vote in relation to the composition. Creditors who are duly admitted are those whose claim has been accepted and confirmed in the presence of the bankrupt person at the stage of proof. In other words, creditors whose claim has been rejected at the stage of proof could not vote. The proof of creditors could be rejected because it does not satisfy the required standard and convince the bankrupt person. However, creditors whose claim has been rejected temporarily or admitted with reservation could also vote in the proposed composition. As per the provisions of Article 1049 of the Commercial Code, the claim of some creditors could be provisionally admitted. Those whose claim is provisionally admitted or admitted with reservation, shall have equal right with those whose claim is duly admitted.

Under article 1084(1) it is said “.... The claims of creditors who do not take part in the voting shall not be taken into account in calculating the majority.” Thus, for the purposes of the composition the number of creditors and the amount they represent is that which obtains the deadline fixed in article 1082(5).

### **6.1.9. Secured Creditors**

The law is not much concerned with the secured creditors. As far as the secured creditors are concerned, they have some kind of property with them belonging to the bankrupt person. As they are holding a certain kind of property, movable or immovable, they would be careless whether the composition is approved or not. As they could satisfy their claims from the proceeds of sale of the property they are holding, in most cases, it would make no sense to them whether the composition is approved or not. That seems why the

law under sub-article (3) of the above-cited Article provides that the creditors enjoying special securities could not participate in voting.

Only unsecured creditors can vote for a proposal for composition. The creditors who have securities cannot vote unless they give up their guarantees. Such a renunciation reduces them to the states of unsecured creditors. In the provisions governing schemes of arrangement, partial renunciation of security of at least one third of the full debt is possible. There is no similar provision in the composition provisions; the conclusion must be that partial renunciation of securities is not possible in the case of compositions. There is no special procedure for the renunciation of securities. I think, a vote for the composition would amount to a renunciation of securities. Compositions do not affect secured creditors therefore, they need not vote on the proposals, if they vote, however, their vote can be interpreted only as an implied renunciation of security. The renunciation of the securities becomes operative subject to the successful conclusion of the composition because renunciation ceases to have effect where the composition is not finalized or is not ratified or is revoked or withdrawn.

That is to say that the creditor regains his position of secured creditors in relation to the property he held in the form of security. If he has already delivered the properties produced in the form of security, he can take it back. Where he is still holding the property, he can retain it. In fact, there is change in status. In the times between his waiver of the right of security and the failure of the composition, he holds it as a person who simply keeps the property of another person without having a legal right in relation to the same property. But where he regains his right of secured creditors, the basis of the right is going to be legal.

#### **6.1.10 Relatives of the bankrupt person**

Not all the original unsecured creditors or all the creditors who renounce their guarantees can vote; the spouse of the debtor, his relatives by consanguinity or an affinity to the fourth degree inclusive and parties who have become assignees of purchasers with

respect to the person mentioned within one year of the declaration of bankruptcy. This is a reflection of the saying “blood is thicker than water.”

The idea behind such restriction seems that since these persons are relatives to the bankrupt person, it is not presumed that they would be fair and free from bias. They, most probably, incline towards the bankrupt person and provoke the other creditors to accept the proposed composition. Especially, where such persons are forming the majority of the creditors, the composition would most probably be approved. Normally, one can simply guess what would the stand of the spouse of the bankrupt person or a relative of him be. The spouse’s and relatives’ personal loyalties to the debtor may override their interests as creditors. This would especially be true in Ethiopia where personal relationships are still very strong. The effect of such personal loyalty is suspected to such an extent that even the persons who acquire rights from the debtor’s relatives within one year are not allowed to vote because of the possible influence the relatives might have on those who acquire from them rights within one year of bankruptcy. Not only the spouse or relative of the bankrupt person, but also persons who acquired a right from the spouse or relative of the debtor could not be allowed to vote. Those who acquired a right within a period of one year are not presumed to be free from the influence of their transferor.

#### **6.1.11 Rights acquired after Adjudication of bankruptcy**

What if a creditor has acquired his right just after the date of adjudication of bankruptcy? One of the cardinal principles is that it is only rights acquired before the declaration of bankruptcy of the debtor that are to be respected. Unless it is in few exceptional cases, all rights acquired before adjudication of bankruptcy are to be respected and the creditor can claim them. But, if the right is acquired after such adjudication, it would not be valid, in principle. Accordingly, a person who has acquired a right after the date of adjudication of bankruptcy of the debtor could not participate in the voting. As his right is not to be respected, he should not be given the right to participate in the voting of the proposed composition.

### **6.1.12 Approval of the proposals of composition by the creditors**

In the case of compositions there is no requirement that a meeting of creditors, where the proposals are discussed and voted on, be held as in the case of schemes of arrangement. After notification by the commissioner, the creditors who oppose the proposal have to notify such opposition within the time specified by the commission or when he sent them notice of the proposals. Creditors who do not notify their dissent within the prescribed time limit are deemed to agree with the proposals. Silence has been made equivalent to an expression of agreement silence does not usually amount to acceptance, however, this provision may be explained by the fact that only a proposal considered to have merit by the commissioner is notified to the creditors, and a high majority is prescribed for approval, even then the court may refuse confirmation where it is not in the interest of the creditors. Therefore, the creditors are not likely to be prejudiced by the provision.

A specific vote of approval is not necessary in the case of unsecured creditors, since silence amounts to approval. In the case of secured, creditors a vote of opposition would be unnecessary. This is because, a composition does not affect the secured creditors and it would be hard to imagine a secured creditor renouncing his security in order to vote against a composition. If a secured creditor does not vote against a proposal he is not affected, and his debt is satisfied in full. But if he votes against a proposal of composition and it is approved despite his vote, he risks a reduction of the debts payable to him. A vote approving the composition would amount to an implied renunciation of privilege. But what happens if the secured creditors communicate to the commissioner that they renounce their privilege but do not include their vote. In such case, their silence should also be deemed to amount to an agreement. The essential point is that they renounce their privileges. Once they renounce their privileges, they are not different from the unsecured creditors. The provision that silence amounts to approval of the composition should apply to them also.

### **6.1.13 Approval of the composition**

Article 1084 of the code concerned with approval of composition. As per sub-article (1) of the above cited Article, in order for the composition to be approved, it has to be accepted by two-third of the creditors representing two-third of the debts of the bankrupt person. In other words, it is not simple majority that is required. A kind of fifty plus one majority does not work. There should be substantial majority approval of the creditors.

A double majority of two thirds in number of creditors and two thirds in amount in the amount of debts is required for the approval of a composition. These majorities are calculated as soon as the time limit fixed in article 1082 (5) lapses. The votes of the creditors opposing the proposal for composition and of the privileged creditors who have given up their securities would have been recorded in the minutes as provided in article 1083 (1), the votes of those creditors approving the proposal for composition would also be recorded in the minutes if they gave express approval (but express approval as we have seen above is not necessary).

The calculation of the majorities would be made by the commissioner, although this is not directly indicated in the composition provisions, it must be the commissioner who must handle this function also since all procedures before confirmation are dealt by him. He is also given the power to supervise and deal with any matters concerning the bankrupt estate. The calculation of the required majorities is simple. The commissioner determines the number of creditors who have the right to vote under article 1083 (2) and those secured creditors who have given up their guarantees and calculates the total amount of the debts. Then, he counts the number of favorable votes (express and implied) and calculate the debt they represent to find out whether the required majorities are present.

What happens if in calculating the prescribed majorities' only one of the majorities is obtained? In France:

“in case the bankrupt has only obtained one of the majorities, the law assumes that, as the propositions of the bankrupt have already been accepted by one of the two minorities, a complete understanding will probably be arrived at between the creditors and the bankrupt at a future meeting, especially if the bankrupt retains the option of modifying, during this interval, his original propositions. The meeting may, in such case, be adjourned for a week ....”

There is no provision in Ethiopian bankruptcy law which allows such a procedure. Where both majorities are not obtained, the proposal for composition would have to be considered rejected. The debtor can perhaps make modifications and improvement after such rejection since there is nothing to prevent a debtor from making a second proposal for composition. But this would involve going through the procedures all over again. The court may provisionally admit the claim of some creditors. Where the court comes to decide later on debts contested or claims provisionally admitted, that may bring about difference in the number of the creditors. The question is whether such difference shall have impact on the approved composition. The law provides that such difference resulting from subsequent decisions that bring about change in the number of the creditors would have no impact on the composition approved. In other words, creditors subsequently admitted would have no right of voting as those creditors who failed to present their dissatisfaction with the proposed composition within a maximum of thirty days. As far as creditors who failed to present their objection on the proposed composition within the period provided by the law are concerned, they are to be considered to have agreed to the proposed composition. They form part of the creditors who voted in favor of the composition.

#### **6.1.14 Set aside confirmed composition**

After the approval of the proposals for composition by the creditors any interested party may apply to the court for confirmation of the compositions. Interested parties in this case would be the creditors or the debtor. The fact that the composition is approved by the creditors does not mean that it is approved forever it could be set aside if there is

sufficient ground to that effect. The court could either confirm the approved composition or set it aside. This indicates that even if the creditors agree that composition is better than bankruptcy, the court, by taking into account different factors, may set aside the composition. The court sets aside or confirms the approved composition where an application to that effect is made. The court decides on confirmation within eight days of the vote approving the proposal for composition i.e. after the expiry of the period for application to set aside the composition. As per Article 1085 of the Commercial Code, it is only creditors who were entitled to vote or who have been accepted as creditors, subsequently that can apply to set aside the composition. Any one of these category of creditors can apply to set aside the composition approved by the two-third of creditors holding two-third of the debts. Have you noted here that the struggle between the creditor? On the one hand those holding two-third of the debts have voted and approved the proposed composition, and on the other hand those who are not satisfied with the composition apply to set aside the approved composition.

Application to set aside to be effective has to be made within eight days of the vote approving the composition; has to be notified to the debtor and the trustees and has to specify the reasons therefore. It can be seen that not only those who opposed the proposal but also those who approved it may oppose the confirmation of the composition. The law requires that those who oppose the confirmation of the composition specify the grounds for their opposition. Such grounds must be those provided by law i.e reasons that would prevent the confirmation of the composition, e.g. that the required majority has not been obtained, or that proper procedure, such a notification to all creditors has not been followed, there are not enough guarantees etc.

Article 1087 provides that, “the court shall not confirm the composition: a) Where the provisions of the preceding articles have not been complied with; or b) Where confirmation of the composition is contrary to public interest or the interest of the creditors.”

Under article 1087 (a) the court has to examine whether i) the provision relating to the proposal for composition have been satisfied ii) the provision under article 1082 (1) have been satisfied. The above consists of the duty of the court of ascertaining whether the provisions of the law have been fulfilled.

#### **6.1.15 Ground to reject the confirmation**

Pursuant to article 1087 of the commercial code, the standard by which the court could reject to confirm the proposed composition is not subjective. There are requirements fixed by law on the basis of which the court rejects the composition. As per Article, of the Commercial Code, there are two important grounds on the basis of which the court could automatically reject the confirmation of the proposed composition. First of all where the provisions of the law preceding Article 1087 are not complied with the confirmation the composition is to be rejected. Where the proposed composition does not fulfill the requirements of percentage offered, time of payment and guarantee; or where the proposed composition is not properly notified to the creditors; where the creditors have not voted in accordance with the law; or where the proposed composition is not approved by the creditors in accordance with the requirements of the law, the court automatically rejects confirmation of the composition. Failure to comply with only one of the above listed requirements suffices for the court to reject confirmation. Therefore, one could not claim confirmation because one or more of these requirements is fulfilled. All the requirements have to be fulfilled as is required by the law.

The court's role however, is not limited the legality of the procedure. It also has to consider the merits of the proposals for composition. The second ground on which the court could reflect to information of the composition is where it finds such confirmation to be contrary to public interest or to the interest of the creditors. The court stands to protect public interest in accordance with the law. As it is one of the organs of the government that stand to represent public interest, it seems logical that the court is allowed to reject confirmation of the composition where such composition contradicts with public interest. The same is true where the composition is contrary to the interest of

the creditors. However, the standard to identify whether the composition is contrary to public interest or interest of the creditors is subjective. The law does not list down the criteria to measure whether the composition is contrary to the interest of the public or the creditors. As a result, it is left to the court to decide whether a given composition is against the interests of the public or the creditors.

Under public interest, the court would have to determine whether it would be appropriate to return the debtor to the business world, it would have to take into account the causes of the debtor bankruptcy, the degree of his errors of judgment, whether the debtor was involved in speculation or had excessive loans etc, and taking into account the bankrupt's conduct during the proceeding determine his honesty.

It can be said that, public interest consists of two elements, the cause of the debtor's bankruptcy and the bankrupt debtor's honesty. Where debtor is convicted of intentionally disposing of his assets to the prejudice of his creditors, "(a) either materially, whether by the assigning or by destroying, damaging, depreciating or rendering useless certain property forming a part of such assets; or (b) fictitiously, whether by removing or concealing property, by relying on or recognizing non-existence debts or claims or by inciting a third person to make fictitious claims, or in any other manner pretending that his estate is less than it is in fact, in particular by means of incorrect accounting, falsified correspondence or a false balance sheet," the composition is revoked as provided in article 1091 (2). If a conviction for fraudulent bankruptcy causes the revocation of a confirmed composition, there is even more reason for not confirming a proposal for composition by a debtor who has been convicted of fraudulent bankruptcy or who has performed acts constituting the offence of the fraudulent bankruptcy. Secondly "A debtor who has caused his own insolvency or who has aggravated it by acting with culpable lack of foresight, whether by failing to keep proper books accounts, by incurring excessive expenditures or by hazardous speculation..." is punishable under article 681 (1) of the penal code. Article 681 (1) has been included in the penal code to protect the public interest. The bankruptcy court may therefore apply the same criteria in effusing confirmation. The court may also consider under public interest whether the debtor had

any previous composition and generally determine whether the debtor deserves to be allowed to settle his debts in a composition; ii) it is provided that the court has to refuse confirmation is not in the interest of the creditors. It is to be noted that the composition is approved by a high majority of creditors; such a high majority is not likely to vote against its interests. However, majorities are not always right and the court has to consider the circumstances under which payment of the agreed percentage is to be made, the adequacy of the guarantees offered, the capacity of the debtor to meet his obligations, in short the court should not confirm a composition when it doubts its proper execution. Finally the court has to check that the privileged creditors are not prejudiced by the composition.

Where an application to set aside the composition has been made, the court decides on the application to set aside and on the application for confirmation of the composition simultaneously. The court has only two options: to confirm the composition or refuse confirmation. The court cannot alter or improve on the proposals for composition.

#### **6.1.16 Confirmation of composition**

As regards the application to confirm the composition, it could be made by any interested party. It could be the creditors who are duly admitted or those whose claim is rejected. Even the creditors whose claim is rejected could apply, if they are so interested. In cases where there is an application to set aside as well as application to confirm the composition, the court is to pass decision simultaneously. In such cases, the court can analyze the reasons presented by the applicants as to why the composition should be set aside or confirmed. However, in all cases, the court has to take into account the report of the commissioner and his recommendations on the proposed composition, the report of the trustees, the observations of parties jointly liable with the debtor, if any. Where the court finds sufficient reasons to set aside the composition, it shall make an order to the effect that the composition be revoked and such order shall be effective as regards all concerned parties.

### **6.1.17 Follow up after confirmation**

Pursuant to article 1088 of the commercial code, where the court has confirmed the proposed composition, the responsibility to follow up implementation of the proposal falls upon the commissioner, the trustees, and the creditors committee. The yardstick by which these persons supervise the implementation is the judgment made by the court to the effect of confirmation. The court is expected to give details as to how the composition should be practical. As per such details, the trustees, the creditors' committee, and the commissioner are to supervise and ensure the carrying out of the composition.

### **6.1.18 Provisions for the execution of the composition**

Under article 1088 (1) "after confirmation, the commissioner, the trustees and the creditors' committee shall ensure the carrying out of the composition in accordance with the detailed instructions contained in the judgment confirming the composition." In the judgment confirming the composition, the court would determine the procedures of payment. For example, whether payment would be made directly to the creditors or by depositing the money in a bank after which the trustee pays the creditors as would have been done if bankruptcy proceeded. The court also establishes how the carrying out of the terms of composition is to be supervised. Since the suspension of bankruptcy is subject to the provisions of article 1088 and since article 1088 provides that the commissioner, the trustee and the creditors committee shall supervise the performance of composition, these organs of bankruptcy are allowed to survive with all or some of their power in bankruptcy, depend on what is provided in the judgment confirming the composition. Thus the sale of the debtor's immovable may be subject to the permission of the commissioner, the trustee may be authorized to deposit the proceeds of the sales of the debtor's property and the creditors committee may be authorized at any time to require information on the state of execution of the composition and on the position of receipts and payments. The debtor may also be required to consult the creditors committee with regard to legal proceedings.

There are no appeals against the decision of the court confirming the composition. An application to set aside may be made to the court which confirmed the composition. The grounds for such an application is limited to fraud founded on either on a concealment of assets or overstatement of liabilities and such an application cannot be made five years after the discovery of the fraud. Thus, the confirmation is final unless fraud can be shown.

### **6.1.19 The effects of composition.**

#### **6.1.19.1 Effects of confirmation on bankruptcy proceedings**

The effect to result from the confirmation of the composition is suspension of the effects of the bankruptcy proceedings. As per Article 1090 of the commercial code, the composition is an alternative to the bankruptcy proceeding. It is a means by which the bankrupt person is allowed to get rid of the bad effects of the bankruptcy proceedings. However, what you have to note here is that the fact that the composition is confirmed does not mean that the bankruptcy proceeding comes to an end.

That is why the law provides for suspension of the effects of the bankruptcy proceedings rather than termination of the bankruptcy proceedings. Article 1090 (1) Provides, “After confirmation the effects of the bankruptcy shall be suspended, subject to the provisions of Article 1022 and 1088.” Thus the effects of bankruptcy are suspended to the extent limited by Articles 1022 and 1088. In order to determine to what extent the effects of bankruptcy are suspended, the effects of bankruptcy have to be determined.

Adjudication in bankruptcy:

1. Deprives the bankrupt of the rights to administer his property from the day on which the bankruptcy is declared.
2. Creates in favour of the general body of creditors on all present and future immovable property to which the creditor is or may be entitled.
3. Matures all debts owing by the bankrupt, and deprives his of the benefit of time which his creditors may have given him in order to facilitate payment.

4. Deprives the bankrupt of some of his rights e.g. he can not be a candidate for parliament, Municipal councils or hold the office of trustee.
5. Creates a universality of creditors vested with legal personality.
6. Entails the appointment of commissioners, trustees and the creditors' committee.

Not all the effects of bankruptcy are suspended by a confirmation of composition. Composition restores the bankrupt to the administration of his property. This is the most important effect of the confirmation of composition, and it is the only effect of the confirmation of composition which will always obtain.

#### **6.1.19.2 Exception to the suspension**

The suspension of the bankruptcy proceeding shall not have effect on the prohibitions or for features provided by law. As per the provisions of Article 1022 of the Commercial Code, one of the effects of adjudication of bankruptcy towards the bankrupt person is the imposition of prohibitions or forfeitures.

The loss of some rights due to adjudication in bankruptcy ceases only when the bankrupt is reinstated. This effect is not suspended by the confirmation of composition because the suspension of the effects of bankruptcy is subject to article 1022. There are no reinstatement provisions under the Ethiopian bankruptcy law. However, payment in full of all his debts restores the debtor to his full rights. Thus the debtor cannot be a candidate for parliament or municipal councils or can not hold the office of trustee until he performs all his obligations under the composition.

The universality of creditors is dissolved by confirmation of the composition because there is no saving clause for it. The creditors may enforce their claims individually or ask the cancellation of the composition under article 1093 where the debtor fails to carry out the terms of the composition.

The suspension of the effects of bankruptcy is subject to article 1088. The commissioner, the trustee and the creditors committee may go on carrying all or some of their activities in bankruptcy depending on the instructions given in the judgment confirming the composition.

As can be seen from the above discussion the loss or rights involved in bankruptcy survives after composition. The second effect, most likely to survive but may not depending on the judgment of confirmation, is that the commissioner, the trustees and the creditors committee may supervise the performance of the composition. Therefore, the fact that the bankruptcy proceeding has suspended as a result of confirmation of the composition would not affect the supervision by the trustees, the commissioner, and the creditors' committee. Normally, one could think of the existence of the trustees, the commissioner and the creditors' committee only in relation to the existence of the bankruptcy proceedings. Where the proceedings suspend, the position of the trustees, the commissioner and the creditors' committee also suspends being part of the proceedings. But as an exception to the above idea, the persons continue to supervise the composition though the bankruptcy proceedings are suspended and the composition is confirmed.

These reflect the blame and its worthiness attached to bankruptcy in Ethiopian bankruptcy law. The first continues the punitive aspect of adjudication in bankruptcy while the second shows that the law does not consider the bankrupt debtor so reliable as to leave him without some kind of supervision is carrying out the terms of the composition.

The confirmation of the composition is binding on all the unsecured creditors whose claims have arisen during the bankruptcy proceedings. Thus these creditors cannot claim more than the percentage of the debts agreed is the composition. Composition, however, does not affect the right of creditors to claim from persons jointly and severally liable with the debtor.

### **6.1.19.3 Effects of conformation on persons jointly liable with the bankrupt person**

Sometimes, there could be persons who are jointly and severally liable along with the bankrupt person. As regards such persons, the creditors can prove in the bankruptcy of all that are jointly and severally liable in case the other persons have already suspended payments. Where the joint debtor has not suspended payment, the creditor can claim the debt from both the bankrupt person and the joint debtor. An important question to be raised is as to what happens to the right of creditors whose claim is secured jointly by the debtor and other persons. The law clearly provides under sub article (3) of Article 109 of the Commercial Code that the composition shall not affect the right of creditors in such cases. That is to mean the creditors whose claim is secured by the debtor and other persons jointly can prove in all bankruptcies, if the joint debtor has suspended payments or claim from the joint debtor.

Thus after getting the agreed percentage in a composition they can sue persons who are jointly and severally liable for the balance. It is for situations like these that creditors enter into an arrangement with joint and several liabilities. But can the person with joint liability with the debtor claim what is paid to the creditors from the bankrupt who is the original debtor. Normally the person who is jointly and severally liable with another debtor has a claim against his co- debtor where he pays an amount in excess of his share. The application of these rules would nullify the benefit the bankrupt debtor gets in a composition.

Composition through a total or partial surrender of assets is possible. The assets, thus, surrendered are liquidated in accordance with the liquidation provisions of bankruptcy. After the surrender of assets in accordance with the terms of the composition, the debtor would be restored to administration of his remaining assets if there was a partial surrender of assets and newly acquired assets if there was a total surrender of assets. The bankrupt would be reinstated to his rights immediately after the surrender of assets since there would be no claim against his estate as provided in article 1117. The universality of

creditors would survive after a composition by surrender of assets because the liquidation of assets is to be done in accordance with article 1101 and following. Since under these articles the liquidation effected by the trustees if means that the creditors cannot claim their rights individually.

#### **6.1.19.4 Effects of confirmation on mortgage**

Trustees are to effect registration of mortgage on the immovable of the bankrupt person in the name of the bankrupt person in the name of the bankrupt estate. In such cases, the estate becomes the mortgagee and the bankrupt person becomes the mortgage. The same is true in relation to the mortgage of the business of the bankrupt person.

The other effects of bankruptcy may survive mortgage either fully or partially through the operation of law or the provisions in the judgment confirming composition. As per sub Article (2) of Article 18089 of the Commercial Code, the fact that the composition is confirmed would not affect the mortgage on the immovable of the debtor. Such mortgage remains registered in the name of the bankrupt estate. The same is true in relation to the mortgage on the business of the bankrupt person in that the mortgage remains registered in the name of the bankrupt estate. But where the proposed composition provides otherwise, the mortgage would not remain registered in the name of the bankrupt estate. The same is true in relation to the mortgage on the business of the bankrupt person in that the mortgage remains registered in the name of the bankrupt estate. But where the proposed composition provides otherwise, the mortgage would not remain registered in the name of the bankrupt estate. If the judgment confirming the composition provides otherwise, the trustees are responsible to register the judgment with the competent authoress. This is with the view to let them to get informed about the judgment confirming the composition.

Thus the mortgage in favour of the creditors survives by virtue of article 1080 (2). The debtor in a composition is required to furnish guarantees for the performance of the terms of the composition. One form of such guarantee is a mortgage in favour of the creditors. Since a mortgage in favour of creditor's already exists, it is allowed to survive and this

does not detract anything from the fact that compositions suspend the effects of bankruptcy.

Depending on the terms of the composition, all debts may be due and payable immediately or over a period of time. Thus, the effect that adjudication in bankruptcy has in maturing the debts may or may not be suspended in fact. However, since the controlling factors are the terms of the composition, it can be said that this effect is suspended.

### **Persons on whom confirmation has no effect**

There are certain creditors not to be bound by the effects of confirmation of the composition. One category of such creditors is creditors holding security in rem which they have not relinquished. As we have discussed, creditors enjoying special security could not participate in voting related to composition. But, exceptionally, such creditors can participate in voting where they have waived their rights in relation to the security. Therefore, where they have not relinquished the security, the composition confirmed would not bind such creditors.

The other category of creditors not bound by the composition are those who establish their claim during the bankruptcy proceeding. These creditors are those who acquire a right after the date of adjudication of bankruptcy of the debtor. Where such creditor has security to guarantee his claim, he could be bound by the composition. But in case where such creditor has no security to guarantee his claim, the composition confirmed would not bind him. The principle is that it is only rights acquired before the bankruptcy proceedings starts that are to be respected. A right acquired subsequent to the date of adjudication of bankruptcy would not be respected and the holder of such right could not claim validly.

It is only the two categories of creditors who would not be bound by the judgment confirming the composition. Except these two categories, the other creditors are to be

bound by the effects of the composition. Whether one has voted in favor or against the proposed composition, the effects are to bind any creditor except those discussed above.

### **Cancellation, setting aside & Grounds to set aside Confirmation**

There are instances where a composition already confirmed could be set aside. The first instance is where there is fraud discovered after the confirmation. The fraud could be either in relation to concealment of assets or overstatement of liabilities. The debtor could conceal assets which actually are existing in his hands so that he could be considered as bankrupt. Such is the situation of fraudulent bankruptcy. He could also overestimate his liabilities that to result in his bankruptcy. Where such fraudulent act of the bankrupt person is disclosed, the composition already confirmed could be set aside. The applicant to set aside the composition can be made by any creditor and it has to be made within five years period from the date when the fraud has been discovered. After the lapse of the five years period, no application could be made and even if it is made it would not be accepted.

The mere fact that a creditor had made an application to set aside the composition is not sufficient. Even if the applicant claims that there was fraud on the part of the debtor, it has to be proved before the court of law. Where it is proved before the court and the debtor is convicted of fraudulent bankruptcy, the composition confirmed shall be revoked. As a result of revocation of the composition, the sureties produced shall be discharged, except those who involved in the fraudulent act that brought about the revocation of the composition. Here it seems logical to discharge the securities because of revocation of the composition. The surety relationship is subsidiary relationship that depends on the main obligation, i.e., the composition. Where the composition is revoked, the surety also comes to an end, as it could not stand by itself. It is the rule under guarantee contract that where the principal obligation is extinguished, the guarantee contract also extinguishes

The second ground on which the confirmed composition could be set aside is due to failure to carry out the terms of the composition. Basically, the composition is an obligation which the bankrupt person undertook to discharge within the period specified therein. Because of different reasons, the debtor may fail to comply with the commitments included in the proposed composition. In that case, an application to set aside it could be presented before the court. The court, after receiving the application, has to notify the guarantors that an application to set aside the composition has been presented and therefore let such guarantors be present in the next hearing. After hearing the applicant and the bankrupt person, the court may decide that the composition be set aside or otherwise. It all depends on the allegation and proof of the applicant.

The composition may be set aside where the debtor fails to carry out the terms of the composition e.g. failure to pay the agreed percentage. This may seem a rather obvious provision, however, it has to be noted that, the payment of the percentage agreed is guaranteed. The creditors have therefore a choice of proceeding against the guarantees or apply to the court for cancellation. Why would the creditors choose to apply for cancellation than proceed against the guarantees? Proceeding against the guarantees involves the individual diligence of the creditor and may take time and cause delay. If the creditors (or one of them) think that such a delay would not be less than the delay involved in the liquidation of assets in bankruptcy, they would apply for the setting aside of the composition. Furthermore, by proceeding against the guarantees, they would get only the agreed percentage, while if they apply for cancellation, they may get the whole of their debts if they have not been paid at all or the remaining part of their debts if part of the agreed percentage has been paid.

A bankrupt who has been restored to the administration of his business by the composition may contract new debts. He may be unable to pay his new creditors while at the same time performing his obligation under the composition; in such a case the new creditors who have not been paid may demand that the debtor be declared bankrupt. A second declaration of bankruptcy automatically cancels the composition. Where the court finds that there is sufficient reason to set aside the composition, it can set aside the

confirmed composition. As a result of the setting aside of the composition, the guarantors would not be discharged. The contract they entered is to discharge the obligations in case the bankrupt person fails to do so. As the composition is set aside because of failure of the bankrupt person to carry out the commitments he proposed, the guarantors should be questionable. The creditors can have recourse against the guarantor. But if the guarantors could be discharged due to the setting aside of the composition, their commitment from the very beginning has not meaning. It is as if there is no guarantee at all.

### **The effect of setting aside of the composition**

The effect of setting aside of the composition as regards the creditors is that they have to be restored to their previous position. The interference of the composition has suspended the rights of the creditors towards the debtor and the estate. While the composition is going on, the creditors could not be simultaneously entitled to enforce their claim against the debtor, as regards the bankruptcy proceedings, and the bankrupt estate. Their entitlement would be against the debtor personally and the guarantor/s who undertook to assure that the debtor discharges the commitments in the proposed composition. As the bankrupts proceeding suspends, the rights of the creditors against the debtor and the bankrupt estate also suspend. But where the bankruptcy proceeding re-opens, the creditors shall be restored to their original rights towards the debtor and the estate.

It is possible that composition takes place by way of surrender of assets of the bankrupt person. Instead of promising to pay a certain percentage of the claim of each of the unsecured creditors, the bankrupt person may agree to the effect of surrender of his assets.

Pursuant to Article 1099 of the com. Co. the procedures are the same to those of the ordinary composition. Whether it is partial or total surrender of the assets of the bankrupt person, the procedures to be followed are the same to those of the ordinary composition. Therefore, the effects of composition would be the same to the ordinary composition and the setting aside also.

One special procedure to be applied is liquidation of the assets surrendered. Once the composition proposed to be effected by surrender of assets is confirmed, the liquidation is to take place in accordance with the procedures applicable in relation to the bankruptcy proceedings. As far as the rules of winding up in the case of bankruptcy proceedings are concerned, the properties of the bankrupt person are to be sold and the proceeds of sale are to be distributed among the creditors. The movable properties of the debtor are to be sold in accordance with the rules of the Civil procedure Code without the presence of the bankrupt person. After sale, the proceeds shall be deposited in a bank account in the name of the bankrupt estate. Note here that the proceeds of sale would not be deposited in the name of the bankrupt person because he is not in a position to manage and administer his properties. For that matter the proceeds of sale no more belong to the bankrupt person because he has surrendered all or part of his properties for the purpose of composition. As regards the immovable of the debtor, it is the trustees who should proceed to sell them with the permission of the commissioner. This is only where no proceeding for the appropriation of the immovable has taken place. In such cases, the immovable properties should be sold within one week period from the confirmation of the composition by surrendering the assets.

If a certain property of the bankrupt person were not included in the composition, such property would not be affected by the composition. In other words, the creditors could not claim to get distribution of proceeds of sale of such properties. Similarly, properties that are acquired by the debtor after the confirmation of the composition would no more form part of the asset surrendered. The composition by surrender applies only to the properties include in the composition confirmed.

Alike the case of the ordinary composition, the composition by way of surrender of assets would not affect the rights of the creditors against the persons jointly liable with the bankrupt person. Where the joint debtor has already suspended payments, the creditor, besides his right in the proposed composition, can prove in the bankruptcy of such joint debtor. But where the joint debtor has not yet suspended payments, the creditor can claim

from such debtor, besides his right in the proposed composition against the principal debtor (the bankrupt person). In short the fact that the composition is made by way of surrender of assets would not affect the rights of the creditors against persons who are jointly liable with the bankrupt person.

A part from the composition based on surrendering assets of the bankrupt persons, it is possible that composition takes place by way of payment of a certain percentage of the claim of each creditor. Where the creditor has received a certain dividend, the right of that creditor towards the debtor shall be the total claim of such creditor minus the amount he received due to the composition. For example, assume that Ato Mengistu is the bankrupt person, who proposed a composition. In his proposal, Mengistu disclosed that he would be willing to pay 80% of the claim of each of the unsecured creditors within ten months period. He also proposed that he would pay every month proportionately and produced sufficient guarantee. W/ro Ketsela was one of the creditors who claim 20,000 Birr from the debtor. She properly proved her claim and that was verified in the presence of the debtor. After the composition was confirmed, Ato Mengistu paid for three months as per his agreement in the composition. Accordingly, W/ro Ketsela received 4,000 Birr along with the other creditors, which is payment of three months in accordance with the composition agreement. Later the composition was set aside because Ato Mengistu failed to be up to his commitment. As a result, the creditors have to be restored to their original right against the debtor. In the given case, as she received payment of 4,000 birr, W/ro Ketsela could not be restored to the right of 20,000 Birr, which is the original right. Rather her claim goes down to 16,000 Birr for the difference has been paid as a result of the composition. Had she received no part of the agreed dividend, W/ro Ketsela would have been restored to her original right to the extent of the 20,000 Birr, which is the total claim she has against the bankrupt person.

If the composition is set aside either because of fraud or because of failure to comply with the commitments the bankruptcy proceeding re-opens. As the composition is proposed in the middle of the bankruptcy proceedings when it fails, it is normal that the bankruptcy proceeding continues from where it stopped.

In order to re-open the bankruptcy proceedings according to Article 1094 of commercial Code the first step to be taken is to prepare inventory of properties of the debtor. It is the responsibility of the trustees to prepare the new inventory. As per the law, the trustees should not waste time in that they have to prepare within a short period of time. The reason why the trustees are to prepare a new inventory is due to the fact that the books, papers and properties are handed over to the bankrupt person. There is a time gap between the handing over and the time when the composition is set aside. Where the debtor has started to implement the composition, there is no reason why he should remain losing the right of administering and managing his affairs, including the properties. That is why the books, papers, and properties are to be returned to the debtor.

In the process of preparing the new inventory, the trustees can make a reference to the previous inventory. It is based on the inventory made during the bankruptcy proceeding that the debtor received from the trustees. Where there is a need, the trustees can consult the authority who affixed a seal. The authority could be either the court or the appropriate authority.

As part of the re-opened bankruptcy proceedings, the trustees are responsible to prove debts, if any. The debts to be proved shall be new ones that come after the composition is confirmed. As regards the debts proved during the bankruptcy proceedings, the trustees are not in charge of them. The debts which have been verified during the bankruptcy proceeding would not be the subjects of the debtor except in few circumstances. The exceptional situations when the debts could be verified again are: first, where there is refusal of payments already made in the time between the confirmation and setting aside of the composition. The other situation is where there is reduction of payments made between the time of confirmation and setting aside of the composition. In all other cases, the trustees should not verify the debts of the debtor.

After the date of confirmation, the bankrupt person takes possession of the books, papers, and property from the trustees. The trustees look possession of them as a result of the

bankruptcy proceedings. After taking possession of the books, papers, and property, the bankrupt person is free to enter into different transactions. Here the idea is that, as a result of the adjudication of bankruptcy, the debtor is to be exposed to several inconveniences including loss of the power to administer and manage his properties. But where he has settle his affairs with the creditors, the bankrupt person is no more under restrictions or prohibitions. As a result, he could enter into different transactions on his own since he is free from the agency of the trustees and the commissioner. An important question to be raised in this connection is as to what happens to the acts done by the bankrupt person after the composition is confirmed.

As per Article 1096 of the commercial code, it is not all the acts of the bankrupt person that are to be invalidated. It is only few of the acts that are to be made invalid. Where the acts of the debtor are found to be fraudulent in that they affect the interests of the creditors, such acts should be invalidated. Here it seems logical that the debtor should not get benefit out of his wrong doings. If he is left free having done something fraudulent, that is not in line with the requirements of the law. Where the acts of the debtor are fraudulent, as far as the rights of the creditors are concerned, such acts shall be invalidated and the debtor would not get benefit out of such acts. Otherwise, as regards all the other acts, it is not necessary to invalidate. As he is left free due to the confirmation of the composition, he should also be free to enter into different transitions that are not meant to affect the interests of the creditors. Note here that an act, which is found to be fraudulent as regards the rights of other person than the creditors, could not be invalidated. The law is concerned only with the rights and interests of the creditors of the bankrupt person.

Where the composition is set aside, the debtor to be deprived of the administration of his property. Bankruptcy proceeding are reopened. A fresh inventory of assets and papers is prepared on the basis of the former inventory and a supplementary inventory may be prepared where necessary. New creditors have to prove debts but former proof of debts are admitted and those debts which have been fully or part paid are rejected or reduced.

The effects of the cancellation of composition on the amount of the debts former creditors is regulated by article 1097 which provides: Creditors prior to composition shall be restored to their original rights in respect of the debtor and the estate.

- a) for the whole of their debts where they have received no part of the dividend; or
- b) for that part of the debt which remains to be paid where they have received part of the dividend.”

Thus those creditors who have got nothing under the composition are entered with the whole of their former debts in the new bankruptcy proceeding. Those who have been partially paid got the remaining part of their original debt. That is, whatever they have been paid under the composition is deducted from the former debt. Those who were paid the agreed percentage in the composition do not have anything in the new bankruptcy. With the payment of the agreed percentage, they cease to be the creditors of the bankrupt debtor and they would not be allowed to prove debt under article 1095(2).

### **Compulsory winding-up**

The bankruptcy proceedings suspend only where the composition is confirmed. Otherwise, the bankruptcy proceeding continues though a composition is proposed. The mere fact that a composition is proposed would not be a ground for suspension of the bankruptcy proceedings. Therefore, where the two-third of the creditors holding two-third of the debts does not confirm the composition proposed, the winding up process continues to run.

The concept of winding up connotes the completion of a certain process or act. Accordingly, where the process of the composition fails, the next step to follow will be the winding up. Compulsory winding up refers to the situation where the properties of the debtor are to be sold and the proceeds used for the satisfaction of the claim of creditors.

The process involves the sale of different properties of the debtor and distribution of the proceeds of the sale among the creditors duly admitted.

### **6.2.1 Sale of the debtor's properties**

As the movable, immovable, and the business of the bankrupt person could not be sold together, the trustees are to effect the sale differently. As regards the movable and immovable, the sale is to take place in accordance with the rules and procedures provided in the Civil Procedure Code without requiring presence of the debtor. After selling the said properties, the trustees shall deposit the proceeds in a bank account opened in the name of the bankrupt estate. The trustees are responsible to open account in the name of the bankrupt estate so that they can deposit the money they collect in the name of the bankrupt person. The main reason why the account could not be opened in the name of the debtor is first, he is incapable to operate bank account, and second, the proceeds from the sale of the properties is no more the property of the bankrupt person.

As regards the immovable, they could be sold only if there are more proceedings for their expropriation. Where there are proceeding for expropriation of a certain immovable belonging to the debtor, the trustees could not sell such immovable. In the absence of proceedings for expropriation before the opening of the winding up, it is the responsibility of the trustees to sell the immovable of the debtor within a week period. In fact the trustees have to get permission from the commissioner to the effect that the sale takes place. The sale of the business of the debtor could also follow the same procedures to that of the immovable. Where selling the movable and immovable property of the debtor could not be effected, the trustees may enter into compromise or arbitration as regards such properties. Where they find it proper, they can transfer the ownership over the properties simply by individual negotiation. In fact, the trustees should not compromise the interests of the creditors since they represent the universality of creditors. But one exceptional thing is that the one week period does not apply to the case of sale of the business.

### **6.2.2 The fate of debtor entitled to assistance from the bankrupt estate**

What happens if the debtor is entitled to assistance from the bankrupt estate? As the estate is to be sold to carry out the winding up process there would be no resource from which the assistance to the debtor could be paid. Therefore, if there is agreement of the creditors' committee to the effect that assistance is given to the debtor and his family, from the bankrupt estate, the assistance shall be fixed by the commissioner. At the time of fixing the amount of assistance, the commissioner has to take into account the proposal of the trustees. The amount so fixed is to be paid from the proceeds of sale of his properties since the winding up process has already started.

### **6.2.3 Involving in business transaction**

Basically, once the winding up process is opened, the trustees are to sell the properties and distribute the proceeds among the creditors entitled. If the properties, movable or immovable, including the business, are to be sold, there would be no means by which the business is to run. But exceptionally, the business of the debtor could run where there is decision of the unsecured creditors to that effect. The unsecured creditors can authorize the trustees to continue the business of the bankrupt person during the winding up. The reason why the secured creditors would have no say on the continuity of the business is because they have properties in their possession and can satisfy their claims from the proceeds of such properties. The secured creditors have no claim in the bankrupt estate because they are entitled to enjoy priority right in the proceeds of sale of the properties in their possession.

Where there is authorization of the unsecured creditors that is not sufficient for the trustees to allow the business of the bankrupt person to run, the commissioner takes responsibility to consult each creditor. It is not by calling the creditors for a meeting but by sending a registered letter to each of the creditors. Where it is not possible to send a registered letter to each of the creditors because of their number, the commissioner can consult by publicizing in newspaper or commercial gazette. To enable the commissioner

consult the creditors, the creditors' committee has to make a request. The commissioner has to notify the creditors to give their response within fifteen days from the date they got the registered letter or the publication in newspaper or commercial gazette. The vote of the creditors has to be submitted within the fifteen days period to the court registry.

The final authorization of the trustees is to be secured only by a resolution to be passed by the majority of the creditors. The resolution has to be passed by at least three quarter of the creditors holding three quarter of the debts. Note here that it is not simple majority or two-third majority that is required. Rather there should be three-fourth majority so that the trustees could carry out the business of the debtor during the winding up. In the resolution of the creditor, three important things have to be specified. The first thing to be specified is about the money allowed for costs and expenses. Depending on the nature of the business to be carried, the costs and expenses vary. If the trustees are left to spend as it pleases them, that still in turn would pave the way to misappropriation of the assets of the debtor. Therefore, it is proper that the creditors in their resolution fix the amount and specify it in the resolution. The second important thing is scope of the powers of the trustees during continuity of the business. While they continue the business of the debtor, if the power is not limited, the trustees may exercise extended power. The trustees are left with an absolute power, sometimes, that may pave a way to abuse and mismanagement of the affairs in relation to the business. Therefore, it is appropriate that the resolution clearly specifies the extent of the power of the trustees in advance. Third, the duration for which the business has to be continued has to be specified clearly. If the creditors think that the business should continue only for a month or two, it has to be clearly specified. This has an implicit effect that the bankruptcy proceedings should not last unnecessarily for a long period of time. Where no time limit is fixed, the trustees may continue the business indefinitely and that would affect the interests of the creditors and that of the debtor as well.

In case the trustees involve in transactions that bring about liability more than what has been fixed in the resolution, it would not be the responsibility of the trustees to discharge it. As per the provisions of Article 1108 of the Commercial Code, it shall be the

responsibility of the creditors. It is not even all the creditors who shall be liable to discharge such liability, but only the creditors who approved the dealing. Such creditors shall be personally liable beyond their share in the assets within the limits of their share, in the assets within the limits of the authorization given by him, and in proportion to their debts. Note here that the creditors' liability would be within the limits of the authorization given by them. Where their claim is less than the authorization given, the liability goes to the personal properties of the creditors.

As far as bulk sale (i.e. sale of all or a substantial part of the debtor's properties) is concerned, it could take place only where there is court authorization to that effect. Before it authorizes the trustees to effect the bulk sale, the court has to hear the commissioner. Where the commissioner has not recommended such bulk sale, the court could not give authorization to the trustees. For the commissioner, the basis to make recommendation would be the resolution of the creditors. It is the responsibility of the commissioner to consult the creditors before he gives recommendation. In order to consult the creditors, the commissioner has to inform to all the creditors by a registered letter. If the number of the creditors makes it impossible to send to each of them registered letter, the commissioner has to publicize in a newspaper or commercial gazette circulating in the area. After each of the creditors is notified and consulted, a resolution has to be passed by the creditors. The lump sale has to be accepted by three quarter of the creditors representing three quarter of the debts. Note here also that it is not simple majority or two-third majority that is required for the resolution of the bulk sale.

Where the creditors have accepted and passed a resolution to the effect that the assets be sold in bulk, the request could be made either by the creditors' committee or by the debtor himself. After the creditors have accepted the sale by a resolution, the court has to confirm the terms of the sale. It seems logical that the court confirms the terms of the lump sale of assets so that it would not give way to manipulation by the trustees or the commissioner. The fact that the sale is approved by the creditors and the court discharges the bankrupt person from his liability towards the creditors. Any claim the creditors have against the debtor could be satisfied from the proceeds of the lump sale of assets. As the

creditors were consulted and have passed a resolution by three quarter of the creditors representing three quarter of the debts, they have consented to the lump sale of assets of the debtor. That in effect means the creditors agreed to get their claims from the proceeds of such sale, but not from any other source. All other matters than the properties that make the subjects of the lump sale are matters falling within the sphere of the individual matters of the debtor.

#### **6.2.4 Distribution of the proceeds**

Assume that the sale of properties, either separately or in lump, has already taken place. The next important question is as to how the proceeds are to be distributed among the creditors entitled to a claim. In order to answer this question, one has to understand what article 1109 of the commercial code said.

As per this Article, it is the duty of the trustees to send timely report to the commissioner. The report has to be on the status of the bankruptcy and deposit of funds in the account of the estate. The trustees are expected to make a report every two months. As they are responsible to administer and manage the properties of the debtor, the day-to-day activities are within the power limits of he trustees. Besides that, the trustees are representatives of the universality of creditors and that of the bankrupt person. As the commissioner does not involve in the daily activities, it is proper that the trustees make timely report. Though they could not withdraw from the account in the name of the estate, the trustees have to inform about the deposit they make in the same account.

The power limit of the trustees is restricted, mostly, to matters related to daily activities in relation to the bankrupt estate. As far as the power to decide the distribution is concerned, it is within the power of the commissioner. However, the trustees are entitled only to make proposal to that effect. In order to fix the amount to be distributed, the commissioner has to take in to consideration the idea of three bodies. First of all, the commissioner has to take into consideration the proposal to be made by the trustees. As has been said repeatedly, the trustees represent the universality of creditors and the debtor

as well. Since they better know the daily events in relation to the bankruptcy proceedings, it is logical that the proposal of the trustees is to be considered. The other thing to be considered is the recommendation of the creditors' committee. The committee can make recommendations on the proposal of distribution to be submitted by the trustees. The recommendation could be either for changing the proposal or for accepting the proposal of distribution. Where he finds it appropriate, the commissioner may change the proposal submitted by the trustees. But if he finds the recommendation of the creditors' committee unjust, the commissioner may set it aside and confirm the proposed distribution.

Where the proposal is changed on the basis of the recommendation of the creditors' committee, the commissioner can order deposit of the changed proposal with the register of the court. After it is deposited with the registry of the court, the commissioner is responsible to notify to the creditors about such deposit. Being informed about the deposit of the proposal, the creditors are expected to submit their comments on the proposal. The time limit within which the creditors are expected to submit is ten days. The comments are to be made by the creditors' proposal. The comments to be made by the creditors are binding up on the commissioner. In fact, the commissioner can take into account such comments, but not necessarily to accept them. By simply considering the comments of the creditors along with the comments of the creditors' committee and the proposal made by the trustees, the commissioner shall fix the amount to be distributed.

Assume that the commissioner has step fixed the amount to be distributed. Then how the distribution takes place is the next. Article 1110 of the commercial code provides the answer to this question. As per this article, the proceeds of the winding up are to be distributed among the creditors only after the costs and expenses; sums applied for the support of the debtor and his family; and sums paid to preferred and creditors are deducted; the remaining amount forms the net proceeds of the winding up and such net proceeds are to be distributed proportionally among the creditors who are entitled. The creditors entitled are those who properly proved their claims and admitted by the trustees during the procedure of proof of debts. Where the creditors have received a certain portion of their claim before the closure of the winding up process, such amount shall be

deducted from the share in the distribution. Some of the instances in which a creditor can receive a certain portion of his claims are, first where there is sale of movables after the proceeds of sale of immovable is distributed. As per the provisions of Article 1065, creditors secured by immovable can participate in the distribution of proceeds of the sale of movables to the extent not satisfied in the distribution of proceeds of sale of immovable. The other instance in which a creditor can get advance payment is where proceeds of sale of movables take place before the immovable, as provided under article 1066 of the commercial code. The third possible situation where the creditor can get payment before the closure of the winding up is where the secured creditors get partial payment from the proceeds of sale of properties.

#### **6.2.5 Setting Aside of Share corresponding to contested debts**

The court could order that some debts, though they are not proved without reservation, are temporarily accepted until final decision is passed on them. An important issue to be raised here is that what if the final decision on such contested debts is not yet made. Where the net proceeds of the winding up process is distributed totally among the creditors entitled, there would be nothing remaining for the creditors of such debts. Because of that, the law has devised a mechanism under article 1111 of the commercial code.

As per this article, a share has to be kept as a reserve for the creditors whose claim has been contested and not yet decided finally. Once the creditors who have proved and admitted have got distribution of the net proceeds of the winding up, the creditors who get entitlement later would be losers. While all of them are equally creditors of the debtor, those whose claim has been contested during the time of proving debts would be unjustifiably discriminated. Therefore, it is logical that their share kept in reserve. The creditors would not get payment in the form of liquid cash. After sale of the properties of the bankrupt person, the trustees are duty bound to deposit the proceeds with a bank account in the name of the bankrupt estate. Neither the trustees nor the commissioner is entitled to withdraw money from such account. Consequently, it is unimaginable that the

creditors get payment in the form of liquid cash. Then the question remains as to how the creditors go payment. As per the law, the payment is to be made by issuing a Cheque to each of the creditors entitled. The trustees are responsible to send the Cheques to each of the creditors and where this procedure is accomplished the amount paid to the creditor is to be specified in the proof of he same creditor or minutes of the inventory of debts.

### **6.3. Closure of the Bankruptcy Proceedings**

The bankruptcy proceeding has to come to an end at a certain point and shall not continue for unlimited period of time. After all, where the procedures required by the law are met, there is no reason why the proceeding has to continue. By closure of the bankruptcy proceedings, we refer to the coming to an end of the proceeding due to grounds provided by the law. In this section, we are going to discuss the grounds for the closure of the bankruptcy proceeding.

There are three grounds for the closure of the bankruptcy proceedings. These are:

#### **6.3.1 Absence of any claim against the estate**

The overall purpose of the bankruptcy proceedings is to liquidate the available properties of the debtor and distribute the proceeds among the entitled creditors. In order to participate in the distribution of the proceeds of the winding up, the creditors have to prove their claim. Those who are holding security also shall prove their claim against the bankrupt person. Though the creditors have proved their claim, because of certain reasons, the claim of creditors extinguish.

#### **Grounds of absence of any claim against the estate**

There are two grounds on which the absence of claim against the estate could be provided. First, where the debtor has deposited sufficient amount of assets to cover the claim of all the creditors and other necessary costs. As it is only the creditors and person

entitled to remuneration who can claim against the bankrupt estate, deposit of the necessary costs shall be sufficient to close the bankruptcy proceedings. In most cases, the debtor would not get benefit out of the bankruptcy proceedings. Consequently, he could take initiative to deposit the necessary amount of asset to cover the claim of creditors and the other necessary costs. Note here that it is not all the creditors the claim of which is to be deposited. Rather it is only the claim of the creditors who have properly proved their claim and accepted by the trustees. The *other* ground on which absence of claim against the estate could be proved is where the debtor proves that he has paid the claim of all the creditors. Normally, where the creditors claim is satisfied, there is no legal obligation up on the debtor towards the creditors. For that matter, where a proof to the effect that the claim of all the creditors is satisfied is presented, the creditors get advantage of it. Had the bankruptcy proceedings continued, the creditors would have got a certain percent less than their claim. As the bankruptcy is declared after proof of the existence of conditions of bankruptcy, the available assets of the debtor could not be compatible with the liabilities.

Where one of the above-discussed grounds is fulfilled, the bankruptcy proceedings shall be closed by order of the court. In order to decide on the matter, the court has to take into account the report of the commissioner. It is the responsibility of the commissioner to present a report showing that the debtor has either paid what is expected of him or has deposited it with the trustees. Note here that the report of the commissioner would not have a binding effect up on the court. It is within the discretion of the court either to confirm the report and based on it to order the bankruptcy closed or to set the report aside and let the proceeding continue. However, it is not within the absolute discretion of the court in that where the debtor has already paid to the creditors or has deposited what is required of him, the court could not order continuity of the proceeding as it would be against the purpose of bankruptcy proceeding.

The judgment of ordering closure of the bankruptcy proceeding has the effect of bringing the bankruptcy proceeding to end and restoring the debtor to his full rights. Note here that

the effect is termination of the bankruptcy proceeding and not suspension of the proceeding.

Had it been suspension, the implication is that there is some future time in which it is to continue again. Where, therefore, it is proved that there is no claim against the bankrupt estate; the bankruptcy comes to an end on judgment of ordering its closure by the court.

The other important effect is restoring the debtor to his full rights. As a result of the adjudication of bankruptcy of the debtor, several effects are to follow. The debtor is to lose the right of administering and managing his properties, his freedom of movement is to be restricted and etc. But where the bankruptcy is ordered to be closed due to absence of claim against the estate, he regains all the rights and freedoms he lost due to adjudication of his bankruptcy. As a consequence, he is free to deal with his properties, to move from place to place etc within limits provided by the law.

### **6.3.2 Final distribution of the product of the winding up**

Where the composition is either cancelled or set aside because of reasons provided by the law, the bankruptcy proceedings continues from where it stopped and ends with compulsory winding up. Compulsory winding up refers to the sale of the properties of the debtor and distribution of the proceeds to the entered creditors.

The net proceeds of the winding up, that remain after deduction of the costs and expenses, the assistance made to the debtor or his family, and the payments made to the preferred creditors, are to be distributed among the creditors who proved their claim and the same is accepted by the trustees. As the net proceed is the only source from which the creditors can satisfy their claims, on distribution of such proceeds, the bankruptcy proceeding comes to an end. The overall purpose for why the trustees as well as the commissioner are appointed is to liquidate the properties of the debtor and distribute the proceeds among the creditors. Once the distribution takes place in accordance with the procedures provided by the law, the bankruptcy proceeding ends.

However, note here that in case a composition has been proposed, the bankruptcy proceeding would not be closed. As we have discussed earlier a composition is a kind of offer the debtor makes to the creditors so that they can settle their affairs amicably. If the creditors accept the proposed composition and it is confirmed, the bankruptcy proceedings suspend. It is only where the composition is cancelled or failed that the bankruptcy proceeding continues. Therefore, due to the confirmation and pending of the composition, the bankruptcy proceeding would not be closed.

### **6.3.3 Insufficiency of assets**

There is a need for different costs and expenses in order to carry out the bankruptcy proceedings. These costs and expenses demand the existence of sufficient assets. The trustees and the commissioner could do nothing without an asset required to undertake the daily activities of the proceeding though they are appointed to carry out the bankruptcy proceedings.

Whenever insufficiency of assets occurs, the court can pass an order to the effect that the bankruptcy proceedings are closed. It could be either based on a report by the commissioner or on its own motion that the court passes an order for the closure.

One could not determine as to when the insufficiency of assets occurs. It could be either at the very beginning of the bankruptcy proceedings or in the middle of the proceedings; or even at the verge of completion of the bankruptcy proceedings. Therefore, the insufficiency could occur at any time in the course of the proceedings.

#### **6.3.3.1 The effects of closure of the bankruptcy**

Once the properties of the debtor are dispossessed as a result of the adjudication of his bankruptcy, the fact that the bankruptcy proceeding is ordered to be closed would not entitle the debtor to take back such properties. The bankrupt person shall remain dispossessed of the administration of such properties. Note here that it is not the right of

ownership that is to be snatched from the hands of the bankrupt person. The trustees administer the properties on behalf of the debtor as an agent of the latter. Therefore, the right of ownership remains with the debtor.

Where debts are incurred by the bankrupt person after the date of his adjudication, the estate shall not be liable for such debts. No person who has acquired a right subsequent to the date of adjudication of the debtor would be entitled to a right against the estate. This is in line with the cardinal principle which provides that only rights acquired before the date of adjudication shall be respected. Where the closure of the proceedings is ordered by the court, no proof of creditors would be accepted against the estate as regards rights acquired subsequently.

As per sub-article 2 of Article 1114, the judgment that orders closure of the bankruptcy proceedings, due to insufficiency of assets, would be restoring the creditors the exercise of their personal rights. As we discussed earlier, as a result of adjudication of bankruptcy of the debtor, all the creditors are to lose the right to proceed personally. The claim of each of the creditors forms the universality of creditors. As a consequence no individual action is allowed. As the general principle requires collective enforcement of the creditors, individual action is to be suspended.

Where the bankruptcy proceedings are ordered by the court to be closed, the right of individual creditors to take individual measures revives. Once a creditor has involved in a bankruptcy proceedings, even if he has already brought a court action, the case has to suspend. In other words, the adjudication of bankruptcy has the effect of suspending a case pending in a court of law. As a result, there would be no way a creditor could enjoy his right in ordinary courts of law. The judgment that orders for the closure of the bankruptcy proceedings shall have the effect of conferring the personal right to each of the creditors. As a result, each of the creditors can exercise the right of bringing court action before the ordinary court of justice or entering into various compromises or agreements as regards his claims against the debtor. Nothing goes wrong if a creditor

approaches the debtor personally and satisfies the whole or part of his claims against the debtor.

### **6.3.3.2 Set Aside the judgment of closure of the bankruptcy**

Set aside of the judgment ordering closure of the bankrupts though it is court order. The judgment ordering closure due to insufficiency of assets could not be final. It could be set aside where certain conditions are fulfilled. Basically, the grounds for setting aside the judgment seem to be fulfilled by the debtor. Consequently, it is the bankrupt person or any other interested person who can apply for setting aside the closure. Normally, it is where he finds it is advantageous that the debtor applies for setting aside of the judgment ordering the closure. Where he is disadvantaged from the effects of the adjudication, the debtor would not apply for setting aside the order of closure. It could be set aside where: *first*, sufficient asset is deposited with the trustees. The main reason for why the bankruptcy proceeding should be ordered to be closed is due to insufficiency of asset to cover the necessary costs to carry out the bankruptcy proceedings. If one deposits sufficient asset to cover the costs of the proceedings, there is still no reason why the closure should continue. As the administrative and other costs of the proceeding could be properly covered by such amount deposited with the trustees, one can get the judgment set aside.

The *other* ground on which the judgment ordering closure would be set aside is when one shows that there are sufficient funds to meet the costs of the proceedings. Sometimes, it may happen that the debtor fraudulently applies for the declaration of his bankruptcy. While he has sufficient assets to cover the debts he owes his creditors, if he is declared bankrupt and later shows the insufficiency of assets to continue the bankruptcy proceedings, the judgment of closure would be set aside in case an application is made before the court and proof to the effect that there is sufficient assets made. Once the debtor is adjudicated bankrupt, there is no reason for why the proceeding should be closed while there is sufficient asset for carrying out the proceedings.

## CHAPTER SUMMARY

Having completed the entire operations described under the previous five chapters above, which constitute what one can call the preliminary procedure of bankruptcy, one comes to the settlement. There are essentially two forms of settlement: the debtor can promise to pay his creditors a sufficiently large amount of his debts in a reasonable time and give them guarantees for the performance of his liabilities. In the first case, a composition is envisaged. But it is necessary to spell out under what conditions this settlement, which is favorable to the debtor, will be allowed. The code included, therefore, a number of texts which regulate the proposal for composition (Art.1081), the examination of the proposal by the commissioner in bankruptcy and notification to the creditors (Art. 1082), and the severe conditions under which the composition must be voted (Arts. 1083-1084).

The composition may be set aside on the application of the interested parties (Application to set aside composition, Art. 1085). It must be confirmed by the court.

The essential result of a composition is to end the effects of bankruptcy (Art 1089-1090), so that the debtor takes over again the management of his enterprise.

Although the supervision of the carrying out of the composition is assured by various methods (Art. 1088), the composition may be set aside because of the fraud of the debtor (Art. 1091), or cancelled when the debtor fails to carry out the terms of the composition (Art. 1093). Articles 1094-1098 contain specific solutions to complex questions raised by the re-opening of bankruptcy proceedings after setting aside or cancelling the composition, or the opening of a second bankruptcy proceeding for non-payment of the new creditors who have become creditors after the composition.

Finally, article 1099 regulates the composition by way of surrender of assets.

When the creditors have not agreed to a composition with the bankrupt person whose property must be sold and the proceeds distributed to each of the creditors entitled to

receive the proceeds, pro rata in accordance with their debts. It is at this point that bankruptcy really acquires its character as a “mode” of execution. I have named this procedure- which for the debtor is the most severe settlement for the bankruptcy- “Compulsory Winding–Up”, which corresponds exactly withto its character (Arts. 1101-1112)

The plan for the distribution of the proceeds of the winding –up, the actual distribution of these proceeds, and the measures taken to protect creditors whose rights have been contested are governed by Articles 1109, 110 and 111 respectively.

Article 1106 regulates the continuation of the business, which is one of the most difficult questions raised by the compulsory winding-up.

Chapter seven, the last chapter of Title II, deals with the closing of bankruptcy proceedings either for insufficiency of assets (Art. 1114-1115) or absence of any claim against the estate by the universality of creditors. This last expression is a technical legal term in French which means that at some moment of the proceeding, it is established that the debtor longer owes anything to his creditors, the universality (masse), which is to say that the creditors (primarily unsecured creditors) no longer have an interest in the bankruptcy proceedings. In this case the court may order the bankruptcy proceeding to be closed (Art. 1117), a settlement similar to the setting aside of the adjudication of bankruptcy provided in Article 988.

### **Review Questions**

1. Essentially, how many forms of settlement of bankruptcy proceeding are recognized under the commercial code of Ethiopia? What are they? Explain their common and different features.

2. Spell out in detail under what conditions composition, which is favorable to the debtor, will be allowed. In relation to this question, do not forget to address the following five important points:
  - i) a number of texts which regulate the proposal for composition;
  - ii) the examination of the proposal by the commissioner in bankruptcy and the notification to the creditor;
  - iii) the severe conditions under which the composition must be voted;
  - iv) the main requirements for approval of composition; and
  - v) how the approved composition is conformed.
3. Discuss in detail the main effects of composition.
4. Compare and contrast the following three important points
  - i) Composition;
  - ii) Compulsory winding up; and
  - iii) Closure of bankruptcy proceeding.
5. Discuss the two grounds that lead to the closing of bankruptcy proceedings.
6. Explain how composition may be set aside on the application of the interested parties and the grounds to set aside.
7. Identify the effects of compulsory winding up and closure of bankruptcy proceeding.
8. At what point bankruptcy really acquires its character as a “mode” of execution? Why?
9. Discusses the plan for the distribution of the proceeds of the winding up; the actual distribution of these proceeds; and the measures taken to protect creditors whose rights have been contested.
10. Continuation of the business is one of the most difficult questions raised by the compulsory winding –up? Why?

## **CHAPTER SEVEN**

### **SCHEMES OF ARRANGEMENT**

Chapter six deals with the closing of bankruptcy proceedings either for absence of any claim against the estate by the universality of creditors or insufficiency of assets. Moreover, we have also seen the two forms of settlement of bankruptcy. In this chapter we will discuss schemes of arrangement which is more or less related to bankruptcy proceeding.

#### **Introduction**

The bankruptcy proceeding has a number of disadvantageous effects against the debtor. Normally the debtor is not interested to face those disadvantages unless he plans to be discharged from liability towards the creditors. Therefore, where he has a plan of being discharged from liability towards the creditors, the debtor continues with the bankruptcy proceedings. But where he has no such plan, he is expected to think of mechanisms by which he could either minimize or totally avoid the bad effects of the bankruptcy proceedings. Of the possible mechanisms, one is a scheme of arrangements and the other is composition. In this chapter we are going to discuss schemes of arrangement in detail.

#### **Objectives:**

A student who successfully completes this chapter will be able to:

- spell out the minimum requirements for the application of schemes of arrangement;
- list out the sever conditions under which schemes of arrangement can only be decided;
- explain the procedure for approval of schemes of arrangement
- elaborate the common and different characteristics of composition and schemes of arrangement;

- discuss the relations among persons responsible for conducting schemes of arrangement proceeding;
- explain the principle that the debtor retains the administration of his property and the effects of schemes of arrangements; and
- elaborate the roles of the court, a delegate judge and a commissioner in the entire procedure of the schemes of arrangement.

## 7.1 Institutions and Officers

Unlike compositions, scheme of arrangements are effected before a declaration of bankruptcy. The institutions and officers involved in schemes of arrangement play slightly different roles. There is also a difference in the terminology used to designate the officers involved in schemes of arrangement. The institutions and officers responsible for the conduct of proceedings in schemes of arrangement are the court, the delegate judge, the commissioner, the creditors meeting and the creditors' committee.

**The Court:** - Since proceeding in schemes of arrangement is part of bankruptcy proceedings it falls within the jurisdiction of the High Court. An application for the opening of a scheme of arrangement is made directly to the court and it can refuse to consider the application if certain prescribed conditions are not fulfilled. After acceptance of the proposal for a scheme of arrangement by the creditors, it is submitted to the court for confirmation.

**The Delegate-Judge:** - The delegate-judge is appointed by the court when it accepts the application for a scheme of arrangement. As the name clearly indicates, he is a member of the court. (The equivalent phrases used to designate him in the French and Amharic versions are "Juge delegue" and "wakildagna" literally, "delegate judge" respectively.) The delegate judge is the equivalent of the commissioner in compositions. Major decisions concerning the estate of the debtor cannot be made without the authorization of the delegate judge. Thus a written authorization by the delegate judge is required for acts such as contracting loans, compromising arbitration or agreements to assignments,

granting mortgages, setting up pledges etc. The delegate judge also presides over the creditors' meeting.

**The Commissioner:** - He is appointed in accordance with the provisions relevant to the appointment of trustees. The rules applicable to the trustee with regard to removal, replacement, liability and remuneration apply to the commissioner. In the French version of the code of the commissioner in schemes of arrangement is designated as “*commissaire au concordat*” and not “*judge commissaire*” as in compositions. In the Amharic version he is designated as “mermari sowy literally “investigating person”. Although the same word is used in the English version of the code to designate the commissioner in both compositions and schemes of arrangement, the commissioner in schemes of arrangement is equivalent to the trustee in compositions. Unlike the trustee the commissioner in schemes of arrangement does not directly administer the estate of the debtor but supervise the debtor administering his property (since bankruptcy has not been declared the debtor is not deprived of the administration of his property). Thus the duty of the commissioner is keeping a watch on the activities of the debtor. If the commissioner finds out that the debtor has concealed part of his assets, fraudulently admitted certain creditors, increased his liabilities done any fraudulent act, he notifies the delegate judge who refers the matter to court which declares the debtor bankrupt.

**The Creditors' Meeting:** - Unlike the case of composition, the creditors are called to a meeting in which they give their approval of the proposals put forward by the debtor. At such a meeting all unsecured creditors holding rights prior to the application for a scheme and secured creditors who have partially or totally given up their security can take part. The proposals of the debtor are discussed at the creditor,s meeting. Every creditor can intervene in the discussion to explain his reason for opposing the scheme or to contest the debts of other creditors. The discussion of the concurrence of debt may help in the ascertainment of debts thus replacing at least partially the verification of debt to be found in bankruptcy proceedings.

**The Creditors' Committees:** If a scheme of arrangement is to be effected through the assignment of property, the debtor and the creditors may stipulate the method of liquidating the assets. If the method of liquidation is not stipulated, the court appoints liquidators to wind-up the estate. It also appoints a creditors' committee of three or five creditors to supervise the wind-up or liquidation. The creditors' committee plays a role in schemes of arrangement only if it is to be effected through a surrender of assets and where a different stipulation with respect to liquidation are not made by agreement between the debtor and the creditors.

## **7.2. Definition**

A scheme of arrangement is a settlement of debts, before a declaration of bankruptcy, between a debtor and his creditors upon payment of an agreed percentage of the total debts, subject to the confirmation by a court. A settlement of debts may also be effected by a total surrender of assets by a debtor in favour of his creditors.

The basic difference between compositions and schemes of arrangement is that schemes of arrangement are effected before a declaration of bankruptcy, several consequences follow from this situation. The debtor retains the management of his business and administration of his property. But means of controlling that the creditors' interest is not prejudiced by the debtor remaining in possession have to be devised. The powers of making the major decisions beyond normal administration with regard to debtor's estate are vested in the delegate judge and cannot be performed without his authorization. The commissioner's powers are limited to supervision of the debtor's execution of authorized acts and do not include direct administration of the debtors estate.

In the case of compositions, the adjudication in bankruptcy and the investigations made by the trustees to whom the administration of the bankrupt's property passed make the ascertainment of the total amount of the total amount of the debtor's property and the possibility of recovering goods in the interest of creditors possible. Furthermore, the procedures of the proof of debts would ascertain the amount that the debtor owes the

concealment of assets or the overstatement of liabilities if not completely prevented is made very difficult with the operation of the institutions of bankruptcy. In the case of schemes of arrangement the creditors have to depend on the good faith of the debtor and the facts furnished by him as regards the total amount of his property, or the amount he owes. Thus the law provides for stricter and more detailed procedure for allowing a scheme of arrangement requiring the fulfillment of prescribed objective (economic feasibility of the proposals) and subjective (conduct and attributes of the debtor) conditions for the granting of a scheme of arrangement to the debtor. The strict rules reflect the objectives of the law that only honest and deserving debtor should be given a chance to make up.

### **7.3. The Application**

The scheme of arrangements is an alternative to the bankruptcy proceedings. It is to be initiated where the debtor thinks that the bankruptcy proceeding has more negative effects than the positive ones. The process of the scheme of arrangements starts with the application. An important issue to be addressed in relation to the application is as to who can apply? When the application has to be made? and to whom the application has to be presented. Article 119 provides “any trader who has or is about to suspend payment and has not been declared bankrupt may apply to court for the opening of scheme of arrangement.....”. Certain conditions have to be met, however, before an application is considered.

Pursuant to the above-cited Article, first of all, the applicant has to be a trader. Unless he has acquired the status of a trader, no one can apply for a scheme of arrangement. A trader is one who is, professionally and for profit purpose, involved in one or more of the activities listed under Article 5 of the Commercial Code. In fact the persons who are considered by the law to be incapable to be traders are to be excluded even if they carry out one or more of the activities listed under Article 5 of the Commercial Code. Therefore, any one who is a trader within the meaning of the law can apply for the Scheme of Arrangement.

The application has to be made in the form of declaration deposited in the court registry. This condition requires that there be a formal application deposited with the court registry. It is not a special requirement but an essential first step to bring the proposals of a debtor within the jurisdiction of the court. There are important documents that have to be attached to the application for Scheme of Arrangement.

One may question as to why the application has to be prepared in the form of declaration. The trader applies for a scheme so that a bankruptcy proceeding would not continue. Once the scheme of arrangements is accepted and confirmed, none of the creditors is entitled to look for the bankruptcy proceedings. As the creditors are to lose the right to claim bankruptcy proceedings, the trader has to enter into commitment to comply with the scheme of arrangement he has proposed. It should not be, therefore, mere agreement to fulfill the proposed scheme; rather it has to be a declaration that he would really comply with the proposed scheme of arrangement. Otherwise, if he simply enters into mere agreement, which could not be strictly binding, the trader may not comply with the proposed scheme of arrangement.

The debtor is required to file; a) the balance sheet of the firm b) the profit and loss account c) a list showing commercial credits and debts, with the names and addresses of his creditors and debtors. The debtor is also required to give the reasons for his suspension or impending suspension of payments. Since the debtor has not been declared bankrupt, the court has no way of knowing the state of affairs of the debtor's business. Thus he is required to submit the accounts of assets and liabilities, profits and loss and a list of his debtors and creditors. This is indispensable information on the basis of which the court can proceed to consider the application for a scheme of arrangement. In addition to these documents the trader has to attach a report giving the reasons for the suspension or impending suspension payments. This report is mainly required to identify whether the suspension of payments is due to the recklessness of the trader or due to reasons beyond his control. Sometimes, the trader may bring about suspension of payments deliberately with the view of escape from the liabilities towards the creditors by creating fake and

artificial scarcity of financial resources, it would not be fair to allow scheme of arrangement. The trader has also to attach a report indicating the reasons why he proposes a scheme of arrangement. The idea here seems that the trader should not propose a scheme of arrangement with the view of evading and affecting the rights of the creditors. Where it is a system devised by the trader to set aside the rights and claims of the creditors through the bankruptcy proceedings, the application for a scheme of arrangement could not be admitted.

The debtor is also required to give an explanation of his failure, he has to show that the failure is not attributable to him only and even if it were that his error or lack of foresight was not so grave. Furthermore, the debtor is required to give reasons which would justify a scheme of arrangement, he would have to try to convince the court under the circumstances a scheme of arrangement is a better solution than a declaration of bankruptcy, not only to himself but to the creditors as well.

The debtor has to show that a) he has been registered with the commercial register for not less than two years or from the opening of his business (if he was in business for less than two years). He should show either that he has been registered from the date of opening of his business or for not less than two years before the date of application of the scheme of arrangement. This requirement is imposed by the law because a debtor who should be given a chance to settle his debts in a scheme of arrangement has to be one who operates within the framework set up by the and fulfilling all the obligations imposed on him by the law (such as registration). Furthermore, the status of a debtor as a trader would not be perfect if he is not registered, because article 48 (1) provides that “any person who fails to register in accordance with the provisions of this code may not hold himself out to be a trader to third parties...”. A business organization which has not registered does not have legal personality in accordance with article 223 thus it cannot even apply to the court for a scheme of arrangement.

That, during the period set out above (a) he has kept proper accounts. One of the duties of a trader, as compared to a non-trader, is to keep books of account. Therefore, in order to

have the application admitted, the trader has to show clearly that he has been complying with the duties of a trader by keeping proper book of account. The state of affairs of a business or enterprise cannot be known unless proper books of account are kept. If a debtor keeps proper accounts whether the figures shown in the account are actually represented by assets and liabilities can be checked. A debtor who does not keep regular accounts has great possibilities of concealing his assets and over stating his liabilities, which might in turn prejudice the creditors in a scheme of arrangement. This possibility is eliminated by requiring the debtor to show that he has kept proper books of accounts for at least two years, prior to his application for a scheme of arrangement.

The other requirement is whether the trader has already suspended or is about to suspend payments. Even if one is a trader, he has to suspend payments or is about to suspend payments. Where he has financial capacity to discharge his liabilities without any problem, the trader has no right to present an application for a scheme of arrangement. As far as suspension of payments is concerned, Article 971 of the Commercial Code has some clues. Accordingly, suspension of payments results from acts, facts, or documents showing that the person is no longer able to meet the commitments related to his commercial activity. Where, therefore, there is sufficient ground to believe that the trader is no longer able to meet his commercial commitments that is sufficient to present an application for a scheme of arrangement. Let alone suspension, the mere fact that the trader is at the verge of suspending payments is sufficient to enable him apply for a scheme of arrangements.

That he has not been declared bankrupt nor made a scheme of arrangement within the preceding five years this requirement clearly answers the issue as to when one can apply for a scheme of arrangement. In addition to the fact of being a trader and suspending or is about suspending payments, the person who applies for scheme of arrangement should not be declared bankrupt. The right to apply for scheme of arrangement comes to an end at the time when the person is declared bankrupt. An important implication of this requirement is that a scheme of arrangement is not to be sought once the person is declared bankrupt. It could be an alternative to the bankruptcy proceedings only where

the debtor is not yet declared bankrupt. Once the debtor is adjudged bankrupt there is no way the same person can look for scheme of arrangement as a mechanism to avoid the bad effects of the bankruptcy proceedings. Here it seems logical that the trader should not be habitual person to enter in bankruptcy proceedings or scheme of arrangement. If he has already been declared bankrupt once or more before the time of applying for the scheme of arrangement that may put reliability of the trader to question. If he is a person who often becomes bankrupt, the reliance on him that he would comply with the proposed scheme of arrangement is to be questioned. The same holds true if the trader has made a scheme of arrangement within the five years period preceding the date of application for scheme of arrangement.

This requirement clearly answers the issue as to when one can apply for a scheme of arrangement. In addition to the fact of being a trader and suspending or is about suspending payments, the person who applies for scheme of arrangement should not be declared bankrupt. The right to apply for scheme of arrangement comes to an end at the time when the person is declared bankrupt. An important implication of this requirement is that a scheme of arrangement is not to be sought once the person is declared bankrupt. It could be an alternative to the bankruptcy proceedings only where the debtor is not yet declared bankrupt. Once the debtor is adjudged bankrupt there is no way the same person can look for scheme of arrangement as a mechanism to avoid the bad effects of the bankruptcy proceedings.

This requirement reflects the principle that only deserving debtors be given a chance to make up. Repeated failures show that a debtor does not have the proper aptitude and skill required of a business man. Past performance can help predict future performance and there is no reason why a debtor who is likely to fail should be given a chance. A trader should also not be allowed to get away by paying only part of his debts by repeated schemes of arrangement. The law imposes a period of five years because objective conditions of commerce might sufficiently change within this period to justify a confirmation of a scheme of arrangements.

The other thing the trader must show is that he has never been convicted of crimes related to artificial bankruptcy. Where the trader has already been convicted of offenses under Articles 680-688 of the Penal Code of Ethiopia, his application would not be admitted. These provisions of the Penal Code regulate the crimes related to fraudulent insolvency, irregular bankruptcy, fraudulent bankruptcy, and fraudulent composition or scheme of arrangement. These are offences related to bankruptcy proceeding and reflect the laws requirement that only honest and deserving debtors should be given a chance to escape the effects of bankruptcy and a fresh start in business.

The trader has to present his application to the court having jurisdiction. It is logical because the applicant is one who has suspended or is about to suspend payment but not yet declared bankrupt. As far as the bankruptcy proceeding is concerned, persons other than the court are to be appointed on adjudication of bankruptcy of the debtor. As the scheme of arrangement is before the bankruptcy proceeding is entered, for the trader is not yet declared bankrupt, there is no other person to receive the application for scheme of arrangement. Neither the commissioner nor the trustees are appointed because there is no declaration of bankruptcy. In the absence of responsible person to carry out the scheme of arrangement, it is only the court that can receive the application of a trader who opts to avoid the negative effects of the bankruptcy proceedings.

#### **7.4 Contents of the Proposal**

An important issue to be raised in relation to the application is as to what should be the content of the application. The contents of a proposal for a scheme of arrangement are set out in Article 1121 which provides:

- (1) The application shall contain the following requirements.
  - (a) an undertaking to pay not less than 50% of the capital value of unsecured debts within one year from the date of confirmation of the scheme , or 75% with in a period of eighteen months or 100% within a period of three years

- (b) a promise to furnish material or personal guarantees to secure the undertakings made under paragraph (a) and giving details of the guarantees.
- (2) the debtor may propose to assign to his creditors all assets held by him at the date of application for a scheme of arrangement where the assets are sufficient to meet payment as provided in sub-article(1).”

As per Article 1121 of the commercial code, basically there are two important things to be forming part of the content of the application. The first thing to form part of other content of the application is a guarantee. As we have discussed earlier, the trader simply enters into commitment to comply with the proposed scheme in the future. Whether the trader will really comply with the undertakings he made could not be surely known at the very beginning. Because of several reasons, the trader may either refuse or fail to comply with the commitment. In such cases, it becomes against the interests of the creditors. With the view of avoiding such risky situations, the law requires the trader to include a promise to furnish a guarantee so that it would be assured that he would comply with the undertaking. The guarantee could be either material or personal.

The second and important is an undertaking for the payment of a certain percent of the claim of creditors. As regards the undertaking to pay, the traders have three possibilities. He may propose to pay 50% of the claim of each of the creditors within a period of one year or he may undertake to pay 75% of the claim of each creditor within a period of eighteen months. It is also possible for the trader to undertake to pay 100% of the claim of each of the creditors within a period of three years. In all cases, he could not undertake to pay less than half of the claim of the creditors. The least he can undertake to pay is 50% of the claim of the creditors. However, note here that it is not the claim of all categories of creditors that is to be undertaken to be paid. The trader is expected to make an undertaking for the payment of claim of the unsecured creditors. As regards the preferred and scored creditors, they have something to guarantee payment and the law does not bother much about such creditors. As they have something in their hands, the secured creditors may not be happy with the undertaking, especially that of 50% and 75%

of the claim. Normally, while one is holding a property of the trader as security to guarantee the whole debt owed by the latter, it is not advisable to look for a year or more for the payment of his claim.

The trader has also another possibility of proposal. Instead of undertaking to pay a certain percent of the claim of each unsecured creditor, he can propose to assign all his assets held on the date of application of the scheme. Note here that it is not future or past assets, but only existing assets on the date of application. If the creditors are willing to take the assets of the trader in their existing condition, then it will not be necessary that they wait for a year, a year and half, or three years. One may raise here a question as to the value of the available assets of the trader. The value of the asset has not to be less than the undertakings of the trade, i.e., 50% 75% or 100% of the claim of the unsecured creditors. Logically, where the value of the asset is less than the value of claim of the creditors, the scheme of arrangement would not be accepted. While they could get 50% 75% or 100% of their respective claim within one year, eighteen months, or three years respectively the creditors would not normally accept assignment of assets the value of which is less than their claim.

Thus the law prescribes a minimum of 50% of the debts payable within one year from the date of the confirmation of the scheme. This minimum also applies where the scheme of arrangement is to be effected through the assignment of the debtor's assets, except that the period of time becomes irrelevant because once the assets are assigned it is up to the liquidators appointed by the court to wind up the sale of the debtors property under the supervision of the creditors' committees.

### **7.5 Consideration of Application**

After the debtor put forth his application in the prescribed form, the provisions of Article 1122 of Commercial Code clearly states that the court may refuse the application when any of the conditions laid down in Art 1120 is not present. In order to refuse the application, the court has to hear the public prosecutor. Note here that the

recommendations of the public prosecutor could not be binding. The court may either consider it or set aside and accept or refuse the application of scheme of arrangement. Note here also that non-fulfillment of even one of the conditions is sufficient for the court to refuse the application.

The public prosecutor may enlighten the court as to the debtor's conviction of offences related to bankruptcy he may also be of help in investigating whether the debtor had formerly been declared bankrupt or made a scheme of arrangement. The court then determines whether all conditions prescribed or a proposal of a scheme of arrangement has been fulfilled and refuses to consider the application if any of the conditions is not fulfilled. Furthermore, the court can refuse to consider the application, even if it is in the proper form where:

A) It is of opinion that the debtor is not in a position to comply with the undertaking required in article 1121. Pursuant to Article 1123 of the Commercial Code notwithstanding that trader has presented his application in the proper form, the court may refuse the application where it thinks that the trader would not meet the undertaking he made. Because of different reasons, the court may come to identify that the debtor is not in a position to comply with the undertaken percentage of payments or the guarantee. In that case, the court may refuse the application for scheme of arrangement. In fact, it is left to the discretion of court to determine whether the trader could meet the undertaking or not. The law has no specific standard to determine that the debtor is in a position to comply with the commitment or not.

This provision should be applied in the clear cases where it is obvious that the debtor cannot fulfill his obligations under the scheme. If the court only doubts the debtor's capacity it should allow the application. This is especially so because a decision of the court in this ground cannot be set aside and would be rather harsh on the debtor. Even if the application is allowed, the court may later refuse

confirmation after the opinions of the delegate judge, the commissioner, the debtor and the creditors (through their votes) is presented to it.

**B)** The debtor has absconded closing his place of business, or has misappropriated or fraudulently reduced the value of part of his estate. This again reflects the law's preoccupation against granting a scheme of arrangement to a dishonest debtor. Even if the debtor shows not to have had a record of criminal conviction or any malfeasance in the past, his behavior subsequent to the application would disqualify him.

After presenting the application in accordance with the requirements of the law, the debtor may disappear from his place of business without appointing an agent to act on his behalf. Where his business has been closed and the debtor has disappeared, there would be no reason why the court accepts the application and entertains it. Rather it would be logical and acceptable to refuse the application as there will be no person to discharge the undertakings made for the payment of claim of the creditors. The same will be true if the debtor has misappropriated the available assets. The fact that he misappropriates his assets indicates that he is not willing to discharge his obligations towards the creditors. Apart from these, the court can also refuse the application for scheme of arrangement where the trader has fraudulently undervalued some of his assets. Such could be the situation where the trader looks for fraudulent bankruptcy or scheme of arrangement as if he were not able to meet his commercial commitments.

## **7.6 The Effects of Refusal of Application**

Assume that the application for scheme of arrangement is refused by the court. The reason could be either because the requirements of admissibility are not in accordance with the requirements of the law or because the court found the debtor not in a position to comply with the undertaking made. What would the effect of such refusal of application be? The court is to order the declaration of bankruptcy of the debtor so long that he has already suspended payments. One of the requirements to apply for scheme of

arrangement is that the trader should either suspend or is about to suspend payments. Accordingly, where the trader has already suspended payments on the date he applied for the scheme of arrangement, there is nothing to prevent the court from ordering adjudication of bankruptcy of the debtor. Once the application is refused, the court has responsibility to protect public interest by not letting the trader to continue with his business and entry into different transactions that could affect the interests of the members of the community. But where the trader is only about to suspend his payment on the date of presenting the application for scheme of arrangement, the court could not order the adjudication of bankruptcy of the trader. This is mainly because one of the important requirements for the existence of a situation of bankruptcy is suspension of payments which can be inferred from facts, acts or documents showing that the debtor is no longer able to meet his commercial commitments.

If the court refuses to consider the application it sets in motion the adjudication in bankruptcy where the debtor has suspended payment. The decision of the court not to consider the application is final. Judgments of the court could be set aside where there is an application to that effect. A person entitled by the law may apply for setting aside the judgment of the court. In spite of that, an application may not be made to set aside the judgment refusing the application of scheme of arrangement. Whether the court refuses due to non-fulfillment of the requirements for admissibility or because of the provisions of Article 1123(1)(2) of the Commercial Code, there is no right to apply to set aside the judgment. But as regards the judgment ordering the adjudication of bankruptcy of the debtor, an application could be made to set aside. The application, as it is relation to the judgment ordering adjudication of bankruptcy, has to satisfy the procedures to be followed in the procedures of the bankruptcy proceedings. The provisions of Article 984 to 988 shall apply in case there is an application to set aside the judgment ordering the adjudication of bankruptcy of a trader who has already applied for a scheme of arrangement. An application to set aside the court's decision to declare the debtor bankrupt can be made. This means that a rejection of an application for a scheme of arrangement does not always result in a declaration of bankruptcy and if a rejection is followed by a declaration bankruptcy there is an appeal.

## **7.7 Opening of Proceeding under Scheme of Arrangement**

Where the court has not refused the application on the grounds discussed earlier and where no application is made to set aside the judgment ordering the declaration of bankruptcy, the next step is to open the proceedings under scheme of arrangement.

As it is the court who received the application, it is logical that the court orders the opening or otherwise. It is within the power limits of the court to refuse or admit the application for the scheme of arrangements.

Pursuant to article 1125 of the Commercial Code, the court can order opening of the proceedings under scheme of arrangement where it considers that there are merits in the application for the scheme of arrangement. As to when the court considers that there is merit in the application is left of the discretion of the court. There is no standard fixed by the law and the court can take into account several factors and determine whether the application has merit in it or not. Of the factors to be considered by the court, the interest of the creditors is the most important. The court can consider the advantage for the creditors if the scheme of arrangement is to be confirmed and continued. For example, assume that at bankruptcy proceedings is ordered and effected, each of the unsecured creditors is going to get only 60% of his respective claim. But the trader has undertaken to pay 75% of the claim of each of the unsecured creditors within eighteen months period. In this case what the court could do is to compare whether it is advantageous to the creditors if 60% of the claim is paid within a short period (a period within which the bankruptcy proceedings is to be closed) or if 75% of the claim is paid with in a period of eighteen months. Sometimes the creditors may get advantaged if the bankruptcy proceeding continues and is closed within a short period of time. In other cases, it could be to the advantage of the creditors if 75% of their claim is paid within eighteen months period. Such payment could be made shortly or at the end of the eighteen months period. Where is paid shortly, the creditors get advantage.

Once the court has determined that there is merit in the application and the scheme of arrangement to be opened, no application to set aside such order could be admitted. This is an exception to the situation where an application could be made to set aside a judgment or order made by the court.

Sub-article (2) of the above-cited Article provides the list of matters to be contained in the judgment. Accordingly, the decision shall contain appointment of a delegate judge and a commissioner. The judgment of bankruptcy shall appoint trustees and the commissioner. Similarly, where the court has accepted the opening of scheme of arrangement by decision, such decision shall appoint a delegate judge and a commissioner. Therefore, the delegate judge to scheme of arrangement is as the trustee is to bankruptcy proceedings. The appointment should follow the procedure of appointment of trustees under bankruptcy proceedings. Accordingly, the law requires the delegate judge to be selected from a list to be kept with the Ministry of Commerce and Industry, who are citizens of Ethiopia (Art. 994).

However, even though their name is in the list and are citizens of Ethiopia, the following persons shall not be appointed as delegate judge: a person who has been declared bankrupt, or a person who has been deprived of civil rights, or a relative by consanguinity or affinity of the debtor to the further degree inclusive, or a creditor could not qualify to be appointed as delegate judge in a scheme of arrangement of a certain trader. As it is true in the case of trustees, the delegate judge by no means acquires the properties of the trader who proposed a scheme of arrangement. As he is to act as the agent of the trader, it is not proper that an agent acquires properties of the principal.

As regards the commissioner to a scheme of arrangement, it is similar to that of a bankruptcy proceeding. But as per the provisions of Article 1127 of the Commercial Code, the provisions of bankruptcy law shall exceptionally apply to the commissioner carrying out a scheme of Arrangement. As per the said Article, the provisions of bankruptcy law applicable to the trustees shall be applied to a commissioner carrying out

scheme of arrangement, i.e. as regards liability, recourse against assets, removal, and remuneration of the commissioner of scheme of arrangement.

The other thing to be contained in the decision is an order in which the creditors shall be called for a meeting within thirty days from the date of the judgment. The fact that the court has found merits and accepted that scheme of arrangement be opened is not sufficient by itself. The creditors have to meet and discuss over the matter so that they could decide whether to confirm the scheme or not. For that purpose the decision of the court should contain an order for calling the creditors. The decision should also contain determination of the period within which the judgment shall be published and notified to the creditors.

As per Article 1128 and 1129 Of the Commercial Code, if there is no list previously prepared and submitted by the trader, the decision should contain a period determined by the court within which the trader submits the list of his creditors. The period should not be more than eight days. In addition to these all, the decision shall contain a period fixed by the court within which the debtor is to deposit sufficient amount of money to cover costs with the court registry. Such period shall not exceed eight days. The costs belong to the necessary costs to run the scheme of arrangement.

The court should establish the period (of not more than eight days) within which the debtor deposits with the court registry a sum sufficient to cover costs and also determines the period (again within eight days of judgment admitting application) within which the debtor has to complete the list of creditors where the debtor has given reasons in his application for not having submitted such list. Where the debtor does not deposit the required sum or the list of creditors within the period ordered, he is declared bankrupt. If the debtor is unable to put forward the money to cover the expenses of the proceedings, it is not likely that he will be able to perform his obligations under the scheme of arrangement. The submission of a list of creditors is essential information; the court may even refuse to consider the application when it is missing. The period of time mentioned is given only when there are sufficient grounds for him not to have completed the list. If

the debtor is unwilling to deposit the list of creditors, it may show that he is not really seeking a scheme of arrangement. Even where he is unable to procure the list he should be declared bankrupt because he failed to produce essential information without which a scheme of arrangement cannot be made.

The order of the court opening the procedure of scheme of arrangement is final. It has to be published by the registrar by means of notices posted at the entrance of the court and by an extract published in a newspaper empowered to publish legal notices. The registrar has to ensure that the judgment is entered in the commercial register.

Failure on the part of the debtor to comply with the requirements of submitting the list of creditors and deposit in sufficient costs will, as per sub article (3) of the above cited article, result in refusal of the application for scheme of arrangement. The court may refuse the application for scheme of arrangement and no applications set aside such order of the court could be admitted.

## **7.8 Effects of Admission of Application.**

### **7.8.1 Effects as Regards the Debtor and his Properties**

As a consequence of declaration of his bankruptcy, the debtor would lose that right to administer and manage his properties. It is the trustees in cooperation with the commissioner who administers and deals with the properties as well as the business of the debtor. The question, in relation to scheme of arrangement, that remains to be answered is that whether the debtor loses the right to administer and deal with his properties. As far as the rules of the law regulating scheme of arrangement are concerned, the debtor is not to lose administration of his properties.

Since a scheme of arrangement is proposed before adjudication in bankruptcy, the debtor retains the administration of his property and the management of his business. In the course of the process of the scheme of arrangement, the debtor remains possessor of his

properties. As the properties remain under his custody, the debtor can administer and deal with his properties and the business. However, this right of the debtor is not without limitation. Some means of controlling that this state of affairs does not prejudice the creditors is therefore essential. To this end a delegate judge and a commissioner are appointed. He can deal with the properties and his business only under the supervision of the commissioner and the guidance of the delegate judge. In other words, the debtor would not be as free as he has been before the application for scheme of arrangements made. As a consequence, he could not enter into transactions that could affect the interest of the creditors, even though such transaction is to bring much profit to debtor. As the delegate judge is there to stand in the footsteps of the creditors, he shall not give way for the debtor to compromise such interests. Therefore, the delegate judge and the commissioner may inspect the books and accounts of the debtor so that they can discharge their respective duties of supervision and guidance.

During the course of proceedings under a scheme of arrangement, the debtor carries out his activities under the direction of the delegate judge and the supervision of the commissioner. In the case of bankruptcy, the debtor could do nothing in relation to his business and properties. Immediately after the declaration of his bankruptcy, the debtor could not enter into any transaction and even if he enters a person who acquires a right as a result could not validly claim such right. The same rule applies in the case of scheme of arrangement. As Per Article 1133 of the Commercial Code, any gift and other gratuitous acts done by the debtor shall not be set up against the creditors. The implication here is that the debtor can enter into any transaction as long as it does not affect the interests of the creditors. But in the course of such transaction, he should not make gifts or other gratuitous acts. If he is found doing such acts, the interest of the creditors should make gifts or other gratuitous acts. If he is found done such acts, the interest of the creditors should not be affected at the cost of such transaction. In other words, persons who acquired a right as a result of the gift or gratuitous acts can not claim the exercise of their respective rights at the expense of the creditors; claims against the debtor.

The written authorization of the delegate judge is required for the major decisions in the running of the enterprise. Thus authorizations required especially for acts not falling within the exercise of normal administration such as contracting loans, the compromise, arbitration or agreements to assignments, granting mortgages, setting up pledges etc. Any of these acts when done without the written authorization of the delegate judge cannot be set up against the creditors. The execution of the above mentioned acts once authorized by the delegate judge would fall on the debtor with the supervision of the commissioner. Thus there is a division of powers, major decisions are made by the delegate judge, and the commissioner exercises the powers of supervision while the execution is left to the debtor.

Any interested party may apply to set aside the orders of a delegate judge within ten days of notice of such order (sent by registered letter). Such application is made to the court by notification to the registry. An application to set aside any decision or act of the commissioner can be made to the delegate judge. The decision of the delegate judge is subject to an application to set aside as described above. What do you think would be the effect if the debtor fails to comply with the above-discussed duties in relation to his acts during the proceedings of the scheme of arrangement? Per Article 1134 of the Commercial Code, the effect of failure on the part of the debtor is declaration of his bankruptcy. Once the debtor has already suspended payments and has applied for scheme of arrangements, it is logical that the court declares the debtor bankrupt in case he fails to comply with the requirements of acts within the period of proceeding of the scheme of arrangement. Let alone failure to comply with the behavioral requirements, the debtor would be declared bankrupt if he is found concealing part of his assets or fraudulently omitted certain creditors. One of the contents of the decision of the court as regards the opening of the scheme of arrangement is list of creditors. If the debtor fraudulently fails to include some of the creditors in such list, he shall be declared bankrupt. However, it has to be noted that the court can declare the debtor bankrupt based on the recommendations of the commissioner, which in turn has to be based on the reference of the delegate judge. The fact that the debtor is declared bankrupt for these reasons would not affect penal sanctions to be imposed based on the Penal Law.

### **7.8.2 Effects as Regards the Creditors**

Creditors holding claims arising prior the judgment opening the scheme of arrangement cannot destrain, acquire a preferred right over the debtor's property or register a mortgage. This all implies that there is no possibility on the part of the creditors to have personally approached the debtor in relation to the claims they had against the latter.

After the application is made the implication is that the bankruptcy proceedings would not be ordered. The only option for the creditors is to look the solutions under the scheme of arrangement as provided by the provisions of the law. The fact that the debtor is adjudicated bankrupt, had it been bankruptcy proceedings, results in lose of the individual creditors to bring individual court action. The credits in effect are expected to be governed by the principles and rules of collective enforcement.

Pursuant to Article 1131 of the Commercial Code, as far as creditors are concerned, there is no possibility of having a right in relation to the properties of the debtor. Even if the creditor has acquired a claim before the order of the court for the opening of scheme of arrangement, the creditors could not distain the properties of the debtor. It is obvious that the creditor could not acquire the properties of the debtor once the scheme of arrangement is applied. Similarly, in the time between application and final confirmation of the scheme of arrangement, no creditor can acquire preferred right over the properties of the debtor. Moreover, no mortgage could be registered for the benefit of a creditor. In other words, the debtor could not enter into transactions that make the creditor mortgagee or the creditors cannot claim the right of mortgagee in relation to the properties of the debtor.

Such act would be contrary to the law and therefore, null. The prohibition is from the date the application has been made until final confirmation. The prohibition applies to unsacred creditors. This prohibition achieves what is achieved by the creation of the universality of creditors in bankruptcy. It avoids the dependence of the creditors'

satisfaction on the diligence of individual creditors. The prohibition lasts until the final confirmation of the scheme because that is the period within which the creditors have to be protected against each other. Once the scheme is approved and confirmed its terms become binding to all unsecured creditors and satisfaction of creditors by other means than those provided in the scheme is not possible. If the scheme is not confirmed the most likely result would be the declaration of bankruptcy in which case the creditors would be constituted in the universality of creditors. If bankruptcy is not declared all the means of satisfying their claims are restored to the creditors.

The other effect of the application of scheme of arrangement is that preemptions and forfeitures shall suspend. If there is a period of prescription running, as a consequence of the application for scheme of arrangement, it suspends to run. If there are creditors holding a right that has no preference, as a consequence of the application made for scheme of arrangement, such debts shall be deemed to be due. As a consequence, the creditor of such debt can claim it as of the time of application. But no interest shall run as of the time of application. Therefore, the creditor of such debts could not claim interest in the time between the application and the final confirmation of the scheme of arrangement. Therefore, the creditors can claim the interest due before the time of application, but not for the time between the application and the final confirmation.

It is only fair that the law suspend the running of time limits when it deprives the creditors of their rights to take action.

The application for a scheme also has the effect of maturing all debts.

### **7.9 Approval of the scheme of arrangement**

The fact that the court admitted the application and ordered opening of scheme of arrangements would not be sufficient by itself. Besides the court's checking of existence of merits in the application, the creditors should have a say on the proposed scheme of arrangement. In order to do so, there should be meeting of the creditors. The issues to

raised in that relation could be as to who calls the meeting and what preliminary tasks have to be accomplished.

The delegate judge fixes the time and place of the creditors meeting within the time fixed the court in the judgment admitting the application of the debtor. The registrar communicates this to the creditors by registered letter or cable together with a summary of the debtor's proposals. The notices are sent to all unsecured creditors holding rights prior to the proposal for a scheme. Besides the court, the delegate judge and the commissioner are responsible to carry out the scheme of arrangement proceedings. In relation to the meeting of creditors, both the commissioner and the delegate judge are to play their respective roles. As far as the commissioner is concerned, he is responsible to prepare inventory of the debtor's estate. Even though the properties and the business remain under control of the debtor, inventory of the existing properties is to be made by the commissioner. It is also the responsibility of the commissioner to proper a report on the acts, affairs and conduct of the debtor in relation to eh proposed scheme of arrangement and the guarantees produced. In other words, has to follow up implementation of the proposed scheme. The commissioner is still responsible to check the list of creditors and debtors. After doing all these, the commissioner has to deposit the report in the court registry not less than fie days before the creditors' meeting converses (Article 1135 of the Commercial Code).

In proceedings for a scheme of arrangement, there are no procedures for the verification of debts, with the finality and effect found in bankruptcy proceedings. The commissioner just routinely checks the list of creditors based on the documents presented by the debtor. This checking does not affect the existence or the amount of the creditors claims. Disputes as to the existence or amount of a debt would be settled in the courts under the usual (non-bankruptcy) procedures. If, however, the scheme is not approved and the court declares bankruptcy, the creditors can prove debts I the procedure of verification of debts in bankruptcy. The detailed report on the affairs and conduct of the debtor should include the causes of the debtor's failure. In the same report the commissioner deals with the

proposed scheme and the guarantees offered, the report has to be deposited in the court registry not less than five days before the creditors' meeting convenes.

In the proceedings for scheme of arrangement the creditors meeting has been preserved. The creditors are called to a meeting in which they give their approval of the proposals put forward by the debtor. At such a meeting all unsecured creditors holding rights prior to the application for a scheme can take part. Since there is no procedure for the verification of debts, the ascertainment of debts may create some difficulty which the law has tried to solve by admitting to the vote contested claims. Thus article 1139(1) provides "the delegate judge may grant provisional admission of debts in dispute in whole or in part, for the purposes of voting and calculation of the majority, but such admission shall not affect the final decision on the standing of such debts."

At the meeting every creditor has to be present in person or be represented by an attorney. Where the creditor is confident that another person can do his best to protect his interest, he can appoint the same to be present in the meeting. The representative of the creditor, however, has to be an attorney. If the creditor could not be present in person at the meeting he can appoint an attorney. Where the creditor opts to be represented by his attorney, this fact has to be entered in the notice calling the creditors to the meeting. But note here that it is not possible that a person other than his attorney represents the creditors.

There are no special requirements for the appointment of an attorney and appointment may be made by an entry made on the notice calling the creditors to the meeting. As regards the presence of the debtor at the meeting, he could be present either himself in person or through his attorney. Still it is not possible for the debtor to be represented by a person other than his attorney. But where it becomes convincing to the delegate judge that the debtor could not be present either himself or represented by his attorney, a special agent can represent him. Note here that the delegate judge has the discretion to determine the situations in which the debtor cannot be present. As the law has not fixed specific situations to that effect it is left to the decision of the delegate judge.

The presence of the debtor is essential for the approval of the scheme of arrangement because at the meeting not only the proposals but the existence of debts is discussed and the debtor is required to furnish the necessary information. The order for the opening of scheme of arrangement appoints the delegate judge and the commissioner to carry out the scheme of arrangement proceedings. While such persons are responsible to carry out the scheme or arrangement proceedings, it would not be proper to think that the judge in the court to preside the meeting of the creditors. Therefore, it is the delegate judge who presides the creditors' meeting.

The creditors' meeting is presided by the delegate judge. The commissioner presents his report and a discussion is opened. At the meeting, after the presence of the creditors and the debtor in accordance with the provisions of the law, the commissioner shall read his reports. The commissioner has to prepare a report as regards the behavior and act of the debtor in relation to the proposed scheme of arrangement, the list of creditors and debtors and the like. Such report has to be deposited with the court register at least five days before the date of creditors' meeting. It is that report which the commissioner reads at the meeting. Following the report of the commissioner, the debtor is to submit his final proposals. If there is a change in the minds of the debtor in relation to the proposed scheme of arrangement that is the time when such changes are to be included. If they agree, the creditors can confirm and approve the proposed scheme based on the final proposal of the debtor (Art. 1136 of the Commercial Code).

Every creditor can intervene in the discussion to explain his reasons for opposing the scheme or to contest the debts of other creditors. One of the points to be discussed is as to why a creditor is not willing to accept the scheme of arrangement. If there are justifiable reasons the creditor could not accept the proposed scheme, which has to be disclosed. And if that reason is convincing, the other creditors also will change their position when it comes to voting. The creditors can also discuss the concurrence of the debts. This seems to be the concurrence between the claim of the creditors and the liabilities the debtor confirms. Where a certain debt is queried, then that is to be included in the minute of the

meeting. In fact the debtor has to give reasons why a debt is not to be accepted and not to participate in the discussion. He has to disclose and give necessary information in relation to the debts claimed by the creditors.

The discussion of the concurrence of debts may help in the ascertainment of debts, thus replacing at least partially the verification of debts to be found in bankruptcy proceedings. The debtor may also intervene either to contest the creditor's claims or to give the delegate judge the necessary information clarifying the status of contested debts. Disputes which cannot be resolved by discussion are disposed of by the delegate judge deciding temporarily to admit the whole or part of the debt contested. The reason why the delegate judge gives provisional admission to the disputed debts is for the purpose of calculating the majority of creditors during voting on the proposed scheme of arrangement. But note here that the fact that the delegate judge has given provisional admission does not mean that the debt is admitted forever. If the final proof indicates that the debt is not valid, then the creditor could not raise the provisional admission of the delegate judge. In other words, it is not the provisional admission given by the delegate judge that overrides, but the final proof and decision that is binding.

Such ruling does not affect the final establishment of the existence or no-existence of the debt. Creditors, who have not been admitted may, at the time of the confirmation of the scheme, appeal against their not having been admitted, where the majority would have been different.

## **7.10 Approval and Confirmation of the Scheme of Arrangement**

### ***I. Approval of the scheme of Arrangement***

The main purpose of meeting of the creditors is to vote on the proposed scheme of arrangement. In order the scheme to proceed, there should be acceptance by the majority of the creditors. In the meeting, the creditors who do not want to accept the scheme can forward and disclose their reasons to that effect. Based on the discussion,

when they vote, those who voted in favor of the scheme should be more than half of the number of the creditors listed by the commissioner.

However, note here that the majority is not simple majority. In other words, it is not that simple to attain the majority required for the confirmation of the scheme. It should be majority of the creditors representing at least two-thirds of all non-preferred or unsecured debts. This does not mean that it is two-third of the number of creditors that should accept the scheme. The number of creditors could be either two-third or less so long as it is majority. But those who accepted the scheme of arrangement should represent at least two-third of the unsecured or non-preferred debts.

In the case of proving debts in a bankruptcy proceeding, it is all categories of creditors that can produce proof before the trustees. But when it comes to the case of voting in favor or against a proposed scheme of arrangement, it is not all categories of creditors that can participate in the voting. As far as the rule of the law is concerned, secured creditors may not vote in a scheme of arrangement. The idea here seems that since the secured creditors have property of the debtor or another person on behalf of the debtor, they could be reckless. Normally, where the property in their hand is sufficient to cover their claim, they demand full payment of the claim without delay. If the debtor has proposed payment of 50%, 75%, or 100% within a year, eighteen months or three years respectively, the secured creditors would not be happy with it. Therefore, the law seems to prevent them from playing havoc in the interests of the unsecured creditors. In other words, let the unsecured creditors determine their fate by themselves.

In principle they may not participate in the voting. But exceptionally there is a situation where the secured creditors could participate in the voting or scheme of arrangement. Such situation is where the secured creditor gives up the security in his hands. In other words, if the secured creditor agrees to waive this right over the security, he can participate in the voting as any unsecured creditor. This is logical because the moment he gives up the security, the previously secured creditor becomes unsecured creditors. As all the unsecured creditors whose claim is accepted can participate in the voting, the secured

creditor, who gave up the security, can also do the same. But one may question as whether the whole or part of the security could be surrendered so that the creditor can vote. It is not mandatory that the creditors surrender the whole security. He could surrender only part of it. But by no means can the creditor vote if he surrenders less than one third of the full value of the debt. The value of the security he gives up should be more than one-third of the value of the debt the claims against the debtor. But sometimes, the secured creditor may have voted without making partial surrender of the security. In such cases, it shall be considered as if he made full surrender of the security if he accepts the scheme of arrangement. This is logical conclusion to be made from the act of the secured creditor where there is no precision. But note here that in case the scheme of arrangement is set aside or cancelled after the secured creditor has already surrendered his security, the surrender shall cease to have effect. In other words, the properties surrender would not more form part of he estate of the debtor. Otherwise, the security enriches the estate of eh debtor.

Where the creditors at the time of the voting do not indicate that the renunciation it is partiality is presumed that they have effected a total renunciation of security. The giving up ceases to have effects where the scheme is not confirmed or is subsequently cancelled or set aside. Apart from the secured creditors, there are persons who shall not participate in the voting of a scheme proposed by the debtor. The debtor's spouse, his relatives by consanguinity or affinity to the fourth degree inclusive, and parties who have become assignees or purchasers with respect to these persons within less than one year before the application for scheme of arrangement would not vote. Even if they are creditors whose claim has been accepted and confirmed by he debtor, such persons could not participate in the voting. Similarly, persons who have acquired a right after the application for scheme of arrangement has been made and admitted could not participate in the voting (Read the provisions of Article 1140 (6) and Article 1083(4) and (5) of the Commercial Code.)

If the discussion of the terms of a scheme is not finished within one day, the creditors' meeting may be reconvened on the next working day without further notice to the

creditors. The scheme is approved by a majority of creditors representing not less the two-thirds of all non-referred or unsecured debts. The votes of the creditors are written in the minutes of the meeting which is signed by the delegate judge, the commissioner and the registrar. Votes in favor of the scheme sent by the creditors either by cable or registered letter within ten days after the minutes have been prepared are recorded on the margin of the minutes and included in the calculation of the majority. Only favorable late votes are admitted. This can be seen as an indication that the law wants the scheme to go through where the dissenting creditors are not present and voting in the creditors meeting. Due to several reasons, some of the creditors could not disclose their position on the date of the meeting. Even if they did not vote in favor or against the proposed scheme on the date fixed for the meeting or on the postponed date, it is possible that they can notify scheme on the date fixed for the meeting or on the postponed date, it is possible that they can notify their acceptance of the scheme by cable or letter. Where such acceptance is notified within ten days after minutes have been prepared, the fact that they have accepted shall be entered in the margins of the minutes. This is the responsibility of the registrar of the court. Such creditors form part of the majority of creditors who voted in favor of the proposed scheme of arrangement.

What happens to the creditors who are not admitted because of different reasons? Basically, a party to a case, who is not satisfied with the decision of a certain level of court or tribunal, can lodge an appeal to the next level so long as there is such possibility in accordance with the procedures of the law. Similarly, the creditors whose claim this not been admitted can lodge an appeal to the court. However, note that there is a limitation attached to this right of appeal. Their appeal could be accepted only where the majority in the voting would have been changed that they have been admitted. In other words, if the majority would not be attained with the addition of such creditors, the appeal may be accepted. Otherwise, the mere fact that a creditor is not admitted would not entitle him to lodge an appeal against his being not admitted. Even if he lodges, the appeal would not be accepted (Article 1139 of the Commercial Code).

As per Article 1142 of the commercial code, the effect of non-fulfillment of the majority of creditors representing at least two-third of the unsecured or non-preferred debts will be declaration of bankruptcy of the debtor. As the debtor has suspended payments, if the proposed scheme of arrangement fails due to vote of the creditors against it, it is logical that the debtor be adjudged bankrupt. The court declares the debtor bankrupt of its own motion based on the information of the delegate judge.

## ***II. Confirmation of the scheme of arrangement***

After the creditors who notify their acceptance by cable or letter are identified and their vote is added to the vote of creditors who were present at the meeting, an application to the effect of confirmation of the scheme of arrangement is to be made. Note here that this is only where the majority of the creditors representing two-third of the unsecured or non-preferred debts have voted in favor of the proposed scheme of arrangement.

Where the double majority of persons (simple) and debts (two thirds) are not obtained, the delegate judge informs the court which adjudges the debtor bankrupt of its own motion. There is no provision covering the possibility that only one of the majorities is obtained. In view of the silence of the law the debtor will have to be adjudged bankrupt. Where the requisite majorities have been obtained, the delegate judge makes an order for the parties to appear before the court within twenty days when the scheme is to be confirmed. Such ordering is to be made in the minutes and before such minutes is signed by a respective person. Before the court hears the application for confirmation of the scheme, the commissioner has to deposit his reasoned order in the registry not less than three days before the application for confirmation is heard by the court and the delegate judge submits a report at the hearing. The order of the commissioner and the report of the delegate judge would contain their considered opinion with regard to the confirmation of the scheme of arrangement.

At the hearing of the application for confirmation of the scheme, the creditors can be heard. If there are ideas the creditors want to raise, this will be the right time. Similarly,

the debtor also would be heard so that he could raise points which he thinks are important in relation to the proposed scheme of arrangement. Read Article 1143 of the Commercial Code.

In confirming the scheme of arrangement the court is not bound by the order it gave admitting the application. The order of admission of the application is temporary and is made without the certainty and objectivity which can be reached after the necessary ascertainment and investigations made by the delegate judge and the commissioner. After approval of the scheme by the creditors, the next step remaining is confirmation by the court. The mere fact that the creditors approved the scheme by majority vote would not suffice. As it stands for the protection of public interest and rendering of fair justice, the court again has to look into the proposed scheme carefully, before it orders enforcement.

In order to confirm the scheme of arrangement the court has i) to be satisfied that all the procedures prescribed by law for the application, admission and approval have been fulfilled.

The important question is as to what matters should be considered by the court before it confirms the scheme. As per the provisions of Article 1144 and 1140(4) of the commercial code, the court shall consider the following matters:

**A. Consider the financial advisability of the scheme with respect to the creditors, having regard to the existing activities and potentialities of the firm**

As a result of the application for scheme of arrangement, the debtor is not to lose the right to administer and manage his properties and the business. In the proposal for scheme the debtor is to produce a guarantee so that his undertakings would be secured. But sometimes, even if there is guarantee and the debtor has undertaken to pay some part or the whole debt within a given period of time, financially the debtor could be found not in good condition. He might have produced the guarantee by entering into another loan, which in turn adds fuel to the fire. Where the court finds that the financial position of the debtor is not reliable because the creditors could not get what has been undertaken by the

debtor, the scheme may not be confirmed. In order to come to such decision, the court has to consider the existing business transactions and conditions plus the potentialities of the business. Sometimes a certain transaction, even though it is not as such profitable currently, could have potential profitability so that the debtor can earn more money in the future. For example, if the firm is engaged in the manufacture of footwear and the firm in question is a minor competitor with other competitors dominating and there is no likelihood that the market for footwear will expand for sometime, then the court would not confirm the scheme, because it would not be financially advisable to confirm the scheme. The likelihood that the firm will recover under the circumstances described is low. The court under this heading may also consider what the creditors would get after the liquidation of assets in bankruptcy proceedings.

**B. Seek the majorities required by law.**

By provisionally estimating the importance and amount of debts declared with a view to establishing whether there is majority, without affecting the final judgment to be given as regards the debts. Since there is no procedure for the verification of debts the court does not have actual and precise knowledge of the amount of debts or the number of creditors. Thus the court is given the power to estimate the amount and importance of debts. Such estimation is to be done in order to avoid prejudice to the creditors' interest. It does not determine the rights of creditors. The majority of the creditors representing at least two-third of the unsecured or non-preferred debts have to approve the scheme of arrangement. Before it confirms the proposed scheme, the court has to assure that such majority has been secured during voting. Note here that the creditor who informed their acceptance of the scheme by cable or letter is to be considered for the purpose of calculating the majority. Some of the debts of the creditors might be disputed because of different reasons. At the time when the creditors and the debtor discuss the debts, certain debts may not be concurrent with what the debtor admits as his liability. In such cases, the delegate judge may grant provisional admission to such debts for the purpose of calculating the majority in the voting. When final decision is made on the disputed debts, the debt could be either disregarded or considered depending on decision. Whatever the

final decision may be, at the time of confirmation before the final decision, the court shall provisionally estimate the importance and amount of the debts declared with a view to establishing whether there is a majority. Such provisional consideration shall not affect the final decision on the disputed debts.

**C. Examine whether the securities offered are sufficient to guarantee the enforcement of the scheme**

The creditors forego at least part of their claims (or have to wait the rather long period of three years for their claims to be satisfied fully) in a scheme of arrangement. The court has therefore to make sure that the percentage of the debt payable under the scheme will be paid to the creditors. The debtor might have undertaken to pay 50%, 75% or 100% of the claim of the unsecured creditors within one year, eighteen months, or three years respectively. However, whatever the undertaking of the debtor is, the court has to check that the securities produced to guarantee the compliance with the undertaking are sufficient to satisfy the claims of creditors. Otherwise, when it comes to implementation, the creditors would suffer a lot in case the securities are below the debt the unsecured creditors claim. For example, assume that Ato Kaleb is the debtor of five creditors. All the creditors together claim 500,000 Birr. Ato Kaleb proposed a scheme of arrangement with his creditors. He undertook to pay 100% of the claim of the creditors within three years period. In order to assure that he will comply with the obligations in the proposed scheme of arrangement, he produced security the value of which is 40,000. In this case as the security is below the claim of the creditors together, the court shall not accept it. Sometimes it may happen that the debtor gives artificial and exaggerated value for the properties he produces in the form of security. If there is no expert who has background in valuation of different properties, the security may be much lower than the claim of the unsecured creditors.

Where the debtor has proposed assignment of all the assets he has on the date of application for scheme, the court still has to ascertain that the value of the assets assigned is sufficient to cover the claim of the unsecured creditors.

**D. Where the scheme of arrangement is affected by a surrender of assets the court has to make sure that the proceeds of the sale will cover at least 50% of the debts**

**E. Consider whether the debt deserves to be granted approval of the schemes taking into account the reasons for his failure**

The key phrase here is “taking into account the reasons for his failure.” The application for scheme of arrangement should contain explanation as to the reason/s why the debtor proposes scheme of arrangement. The reason for such proposal should be convincing and justifiable at least in the eyes of a reasonable person. If the court finds that the reason why the debtor proposed scheme of arrangement is not convincing, it can decide that the debtor does not deserve approval of the scheme. The reasons for the failure have to be these which would normally cause failures in the commercial world. That is the cause should not be attributable only to the debtor if the cause for his failure were: negligence in the management of his business, grave errors of judgment, speculation or excessive loans the court can refuse confirmation. The reason why he proposed the scheme could not be taken as justifiable.

In giving its decision the court cannot be bound by the vote of the creditors even if it is unanimous. Where the secured creditors have given up their securities for the purpose of participating in the voting they surrender the securities. Such surrendered properties form part of the estate of the debtor. As a result, the estate increases by the properties so added to it. This will have implication in the calculation of the majority required by the law in that previously the claim of the secured creditors was not considered. But once they surrender the securities totally or partially, their claim forms part of the debt to be considered for calculating the majority.

After considering the above discussed important matters, the court either confirms the scheme of arrangement or adjudges the debtor bankrupt. If the matters are complied with, the court confirms the scheme of arrangement. But where it does not confirm, then it

orders the adjudication of bankruptcy of the debtor. As the debtor has already suspended payments, it would be appropriate if he is declared bankrupt so that the creditors can satisfy their claims in accordance with the procedures of bankruptcy proceeding.

In its judgment confirming the scheme the court determines, the sums to be deposited to cover dividends due in respect of declared debts, that is if payment is to start immediately, the amount to be set aside to cover debts in dispute creditors holding contested claims, even if allowed to vote are not covered by the guarantees in a scheme of arrangement. There is the possibility, however, that the creditor may establish the existence of the debt. For such an eventuality the law requires that sums to cover the contested debts be deposited. This may also deter the debtor from contesting too many debts if he is not sure that the debt cannot be established. The court in its judgment confirming the scheme also fixes the procedure for the payment of the amount due at successive intervals, unless the matter referred to the delegate judge.

If the debtor and creditors do not stipulate differently, the court appoints liquidator to wind-up the estate under the supervision of a committee of three or five creditors in the case where the scheme is to be effected by an assignment of all the debtor's property. As it will be difficult that the creditors themselves sell the assets and get the proceeds among themselves, it is logical that the court appoints a liquidator. The liquidator's function will be to realize all the existing assets of the debtor that are assigned and change into money. The proceeds of the sale will be distributed among the creditors in accordance with the law. It is in accordance with the proportion of claim of each creditor that the distribution is to be made. This is because in case of assignment of assets, the debtor is not undertaking to pay a certain percent of the claim of the unsecured creditors. In the case of a scheme by assignment of property the debtor does not have any obligations remaining after the judgment confirming the scheme.

The creditors' committee is to look over the proceeding of scheme of arrangement. Where the liquidator realizes and distributes the proceeds of sale among the creditors, there is a need for a body to supervise the winding up. That is why the creditors'

committee is to be formed by the judgment of the court. In fact in its judgment the court shall fix the details as regards the functions of liquidator as well as the creditors' committee. Read Article 1145 of the Commercial Code. The judgment confirming or refusing confirmation is published in accordance with the rules on the publication of a declaration of bankruptcy.

An application to set aside the judgment confirming the scheme may be made by the creditors who have opposed the scheme or any interested party within five days after the minutes have been prepared. Even the creditors who have voted for the scheme may apply for the setting aside of the scheme. The reasons for the application have to be given and notified to the debtor and the commissioner. The reasons for the setting aside should be the non-fulfillment of the conditions prescribed by law for the admission of the application or for the confirmation of the scheme. The debtor and the creditors who have applied to set aside the scheme may appeal against the judgment, within fifteen days from the publication of the judgment. Notice of the appeal has to be served on the debtor, the commissioner and all parties to the proceedings.

### **7.11 Effects on Debtor**

Once the scheme of arrangement is confirmed by the court on fulfillment of the requirements of the law, the rights of the debtor are to be restricted to some extent. Accordingly, the debtor may not dispose of or charge his immovable property. Although the properties remain under his custody, the debtor's right to dispose his immovable properties is restricted. He could also not charge his immovable or agree to rights of pledge (in relation to his movables) or set aside any part of his assets. But there are exceptional situations where the debtor could either dispose or charge his immovable, or pledge or set aside part of his assets. The first situation is where it is so provided in the scheme or in a resolution to be adopted in accordance with the law. The other situation is where the nature of his business requires such disposal. Charging, pledging, or setting aside part of the assets. But where the debtor does things contrary to the two exceptional situations, such act of the debtor would not affect the interest of the creditors existing

before confirmation of the scheme of arrangement. In other words, where there is a need to decide on conflict or interest between the creditors who acquired a right before confirmation of the scheme and after it, the right of creditors who acquired prior to the confirmation prevails.

### **7.12 Effects on Creditors**

The judgment confirming the scheme binds all creditors prior to the opening of the proceeding for the scheme but their rights against persons jointly and severally liable with the debtor, sureties and as ignees is not affected.

Pursuant to Article 1150 of the Commercial Code, the effect of the confirmed scheme will be that it binds all the creditors who acquired their rights before the opening of the scheme of arrangement. Whether the creditor is secured or unsecured; preferred or otherwise, all creditors are to be bound by the scheme confirmed by the court. Similarly, whether a creditor has voted in favor or against the proposed scheme of arrangement, once the court confirms it all creditors are to be bound by it. In other words, the creditors who voted against the proposed scheme of arrangement could not claim not to be bound by the scheme. But the right of all creditors, whose claim is jointly and severally guaranteed by other persons along with the debtor, would not be affected. For example, assume that Ato Wondimu is the debtor of Ato Melesse. The claim of Ato Melesse was guaranteed by the debtor and W/ro Fanaye. Ato Wondimu proposed a scheme of arrangement and such scheme was approved by the majority of creditors and confirmed by the court. In this case, due to the fact that the scheme is confirmed, the right of Ato Melese against the guarantor (W/ro Fanaye) would not be affected.

The carrying out of the scheme is supervised by the commissioner in accordance with the procedure laid down in the judgment, in particular the commissioner informs the delegate judge of any fact likely to prejudice creditors. Thus supervision continues even after the confirmation of the scheme.

As any party who is not satisfied with the orders of decisions of a given tribunal can look for appeal or apply to appropriate tribunal to reconsider if there are legal grounds to that effect, it is also possible to apply for setting aside or lodge an appeal against the judgment confirming the scheme of arrangement. The application to set aside or an appeal could be lodged by any of the creditors who voted against the scheme or by any interested party. The application for setting aside of the judgment has to be made within five days from the date of preparation of the minutes of the meeting of creditors. The application shall contain the reasons why the scheme should be set aside. It should always be on justifiable grounds that a person applies to set aside the judgment confirming the scheme of arrangement. Finally, the fact that an application for setting aside the judgment has been made shall be notified to the debtor and the commissioner. This could enable the debtor and the commissioner to come up with a defense against the reasons of the applicant for setting aside the scheme. If it is an appeal against the judgment, it has to be made within fifteen days from the publication of the judgment. Still in the case of appeal, it is the person who made an application to set aside who can lodge the appeal. The fact that an appeal is lodged has to be notified to the debtor, the commissioner and all parties to the proceedings.

After confirmation the scheme of arrangement may only be set aside on the grounds of fraud founded on the concealment of assessor overstatement of liabilities. An application to set aside cannot be made five years after the discovery of fraud. A conviction for the offence of fraudulent bankruptcy also revokes a scheme of arrangement. The scheme of arrangement may also be set aside where the debtor fails to carry out the terms of the composition.

### **7.13. CONCLUSION**

Title III of Book V is devoted to schemes of arrangement (Arts. 1119-1153). In preparing the text of these Articles, the drafter has adopted numerous solutions from the Italian law of 1942 because it contains probably the best technical regulation of the institution.

The minimum requirements which an application for a scheme of arrangement must contain are severe (Art. 1121), and even if the application is in the proper form the court may or even must refuse to consider the application for any of the reasons set out in Article 1123.

The entire procedure of schemes of arrangement is carried out under the strict supervision of the court, with a delegate judge and a commissioner playing the most important roles. (Art. 1125)

Articles 1131 and 1132 spell out the effects of the application for a scheme of arrangement and the principle that the debtor retains the administration of his property, except that certain particularly dangerous acts do not affect creditors (Art. 1133), in accordance with the rules of the “suspect period”.

The scheme of arrangement required a close collaboration between the creditors and debtors (Arts. 1136): it can only be decided upon under severe conditions as to majority and quorum (Art. 1140). The procedure for approval by the court is more closely regulated than the procedure for the approval of the composition of bankruptcy (Arts. 1143 and 1144).

## REVIEW QUESTION

1. What are the minimum requirements that an application for a scheme of arrangement must contain? Explain them in detail.
2. Compare and contrast schemes of arrangement visa-a-vise composition.
3. Even if the application for schemes of arrangement is in the proper form the court may or even must refuse to consider the application for any of the reasons set out in Article 1123. What are the justifications behind this article?
4. List out the roles of the court, a delegate judge and a commissioner in the entire procedure of the schemes of arrangement.
5. Explain the relations among persons responsible for conducting schemes of arrangement – their interactions intra-and with other.
6. What are the effects of the application for schemes of arrangement?
7. Explain the principle that the debtor retains the administration of his property- the rules of the “suspect period”.
8. Compare and contrast the procedure for approval of schemes of arrangement by the court visa-a-visa the procedure for approval of the composition of bankruptcy.
9. Proof the following assertion: ***“The scheme of arrangement required a close collaboration between the creditors and debtors than composition.”***
10. Discusses the severe conditions under which schemes of Arrangement can only be decide.

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