



**The Role of Workouts under the US and the Ethiopian Bankruptcy Law:
A Comparative Analysis**

BY: Asress Gikay

LLM Short Thesis
Comparative Bankruptcy law
Thesis Advisor: Prof. Tibor Tajti
Central European University
1051 Budapest, Nador Utca 9
Hungary

TABLE OF CONTENTS

TABLE OF CONTENTS	I
INDEX OF ABBREVIATIONS	III
ABSTRACT	V
KEYWORDS	V
INTRODUCTION	1
CHAPTER ONE	7
WORKOUTS: MEANING, FUNCTIONS AND DRAWBACKS: US PERSPECTIVE	7
1. Introduction	7
2. The definition of Workouts	7
3. Some Related Concepts: Composition, Reorganization, and Scheme of Arrangement	9
3.1. Composition	10
3.2. Reorganization	12
3.3. Scheme of Arrangement	12
4. The Distinctive Feature of Workouts	14
5. The Benefits of Workouts	15
6. A Drawback in Workouts: Holdout Problem	17
CHAPTER TWO	20
THE LEGAL FRAMEWORK REGULATING WORKOUTS IN THE US AND ETHIOPIA	20
1. Introduction	20
2. Contracts	21
2.1. Pre-default bankruptcy contract and Workouts	21
2.2. Validity of Workouts in Contract	23
2.2.1. US Contract Law	23
2.2.2. Ethiopian Contract Law	25
2.3. The Bankruptcy code	26
2.3.1. Section 351(a) (1) US Bankruptcy Code	26
2.3.2. The Ethiopian Commercial Code Provisions on Bankruptcy	29
2.3.3. Workouts Specific Problem: The Effect of Debtor’s Default on the Workouts	33

2.4. Viability of Adopting Workouts in the New Ethiopian Bankruptcy Law	34
CONCLUSION AND RECOMMANDATIONS	37
BIBLIOGRAPHY	39
Books	39
Articles	40
Legal Sources	41
Statutes	41
Cases	42
Others	42
1. H.R. REP. NO. 95-595 SEPT. 8, 1977	42

Index of Abbreviations

Art.	Article
Bankr.	Bankruptcy
Ch.	Chapter
D.	Division
ET AL	and others
Et seq	and the following
Eur J Law Econ	European Journal of Law and Economics
H.R.	House of Representative/USA
Inc.	Incorporated
JAL	Journal of African Law
JEL	Journal of Economics and Law
Ltd	Limited liability company
Neg. Gaz.	Negarit Gazette (i.e., Official Gazette of laws of Ethiopia)
No.	Number
Nov.	November
NY	New York
p/pp	page/pages
REP.	Report
Sec/secs.	Section/sections
Univ.	University
US/USA	Unites States/United State of America
U.S. SC	United States Supreme Court

U.S.C

United States code

U.S. D.C

United States District Court

Vol

Volume

ABSTRACT

In this thesis, it is claimed that unlike in the US bankruptcy law where the court should decline jurisdiction over bankruptcy petition on the ground of the existence of effectively negotiated workouts, the Ethiopian Bankruptcy law lacks rules encouraging workouts. Moreover, due to the absence of practical cases showing the interplay between bankruptcy law and contract law coupled with detailed provisions in the Ethiopian commercial code on composition, courts would be skeptic to enforce workouts through ordinary contracts. This is mainly because the rules on composition, the closest terminological equivalent workouts in the US law, highly regulates payment proposal of the distressed debtor and gives the court wide discretion to confirm or reject the proposal for composition. Hence, any agreement akin to composition is likely to be seen in light of rules of composition that may render workouts unenforceable on account of failure to meet the requirements of composition. Hence, the revised provisions of the Ethiopian commercial code pertinent to bankruptcy should encourage workouts through explicit reference and inclusion of detailed rules regulating workouts specific problems since unlike the US law where courts can give solution to specific problems through cases, there is no chance of setting precedents through court decisions to fill the legal Lacunae.

KEYWORDS

Bankruptcy, Workouts, Reorganization, Composition, Scheme of Arrangement

INTRODUCTION

“The importance of bankruptcy law lies in part in making the resolution of multiple creditors’ conflicting claims more orderly and thereby enlarging the amount of their joint recovery.”¹ A well designed bankruptcy procedure can facilitate economic growth.² Classically, Bankruptcy law achieves its broad goals mainly through liquidation and reorganization.³ It is suggested that an economically viable debtor should resort to a third option which is out-of- court settlements ⁴ (hereinafter”workouts”). Workouts are effective mechanisms through which a financially distressed debtor can make a voluntary arrangement with creditors and avoids liquidation. It is the best way to maximize the value of the bankrupt debtor’s asset and continue business with gradual resurrection of the businesses to a profitable undertaking with the assumption that the arrangement works successfully. Among others, workouts, avoid cost of liquidation and reorganization including costs of litigation and legal as well as professional fees⁵, save loss of investment opportunities⁶, maintain the smooth relationship between the bankrupt debtor and its customers.⁷ For these reasons, it is suggested that workouts should be utilized by financially viable debtors to remain in the business by structuring their debt with creditors through Workouts.⁸ As will be shown later in this thesis, workouts in bankruptcy are not the most utilized means of settling bankruptcy. In the US bankruptcy law, which is considered debtor friendly, workouts are

¹ Kenneth W. Dam, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT (Brookings Institution press, Washington D.C., 2006), p. 195.

² *Ibid.*

³ Maria Brouwer, Reorganization in US and European Bankruptcy law, Eur J Law Econ (2006) 22:5–20, pp. 16 & 17.

⁴ Sris Chatterjee Et Al, Resolution of Financial Distress: Debt Restructuring Via Chapter 11, Prepaid Bankruptcies and Workouts, Financial management, Vol. 25, No. 1, 1996 at 5, p 5.

⁵ MERTON H. MILLER ET AL, CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES (Cambridge Univ. Press, 1996), p. 310.

⁶ *Id.*, p. 313.

⁷ See Re Colonial Ford, Inc., 24 B.R. 1014 (Bankr. D. Utah 1982).

⁸ See *Supra* note 4.

frequently resorted to and courts have enforced it in various circumstances. To the contrary, many other legal systems, like Ethiopian bankruptcy law - one of the legal systems analyzed herein - do not encourage resort to such out-of-court mechanisms.

The typical solution to a distressed debtor is to resort to bankruptcy law which enables the debtor and creditors settle any claims collectively through liquidation or reorganization.⁹ However, liquidation, besides being expensive is aimed at facilitating the exit of the firm from the economy. It is true that it is desirable for inefficient and failing firms to exist from the market and leave room for efficient firms and to that end efficient bankruptcy law makes the exit faster.¹⁰ But, this is not certainly the best solution for a firm that wishes to remain in operation. Thus, workouts have been recognized as the most efficient alternative solutions to corporate bankruptcy in such situations.¹¹

As will be shown later, workouts are effectively utilized under the US bankruptcy system. But no research has ever been conducted as to the existence and practicability of workouts under the Ethiopian bankruptcy law. It is beyond doubt that Ethiopia should use its bankruptcy law to positively contribute to the current establishment of sustainable market economy. The role of workouts in helping to settle bankruptcy out-of-court and helping to save cost of doing business is not negligible. It is admitted however that, the entire bankruptcy law of Ethiopia has not been tested in practice.¹² Therefore, the utilization of workouts to settle bankruptcy claims might not be one of the burning issues as the system stands today. However, this issue should be dealt with before the revised commercial code provisions on bankruptcy that will remain in force for another

⁹ *Supra* note 3.

¹⁰ See *Supra* note 1.

¹¹ See *Re Colonial Ford, Inc.*, 24 B.R. 1014 (Bankr. D. Utah 1982).

¹² THE USAID, ETHIOPIAN COMMERCIAL LAW & INSTITUTIONAL REFORM AND TRADE DIAGNOSTIC (Jan 2007), p. 52.

long time perhaps a century, come into force, in order to avoid any future idiosyncratic solutions. Thus, in the present setting, a research such as this one is of practical significance to give an insight to the legislator to consider if it is wise to introduce workouts as one of the solutions to insolvency situations.

The jurisdictions under comparison belong to different legal family and socio-economic facts. The US is in common law system while Ethiopia is civil law country. But several reasons aptly justify the comparison. Firstly, the dichotomy of civil law-common law is losing its historical sharp contradistinction as statutes are enacted in common law system and cases laws develop in civil law system to some extent.¹³ Secondly, the US bankruptcy law and practice has been tested for several years also affecting the bankruptcy laws of other systems including the continental ones.¹⁴ Importantly in this regard, the US bankruptcy code, as will be discussed later is pro-bankruptcy and Debtor¹⁵ as opposed to the other system where for instance, going bankrupt is considered a crime, bankruptcy crime being defined very broadly or failure to file bankruptcy entailing criminal liability.¹⁶ The effect of this is that in the US system of debtor friendly bankruptcy law is that, as many bankruptcy proceedings as possible can be filed and an attempt to avoid liquidation is made

¹³ See Salvatore Mancuso: The New African Law: Beyond the Difference between Common Law and Civil Law, Annual survey of International & Comparative law (Vol. 14, Issue 1.Article 4), p.7.

For the Law Introducing precedents in Ethiopia, see Legal Notice No. 42, Federal Democratic Republic of Ethiopia, Federal Negarit Gazette, Proclamation No. 454/2005: A proclamation to amend Federal courts Proclamation No. 25/96, Article 2(1). This proclamation in its relevant part adds sub- article 4 to article 10 of the amended law. The addition reads “ Interpretation of a law by the Federal Supreme Court rendered by the cassation division with not less than five judges shall be binding on federal as well as regional council at all levels. The cassation division may however render a different legal interpretation some other time.” Ethiopia is a civil law system taking most of its codes from continental legal systems such as German, France, and Switzerland. Historically, precedents were of no importance under the Ethiopian law. However, since this law, decisions of the Ethiopian Federal Supreme court Cassation Bench, to rectifying basic error of law committed by High court or the Regular Bench of the Supreme Court itself have precedent effect. The author need not go any further to show the convergence of the two legal families as this is not the primary target here.

¹⁴ Maria Brouwer, Reorganization in US and European Bankruptcy law, Eur J Law Econ (2006) 22:5–20, pp. 16 &17.

¹⁵ *Id.*, at 11.

¹⁶ See German Criminal code (Strafgesetzbuch), promulgated on 13 November 1998 (Federal Law Gazette I, p. 945, p. 3322), Chapter 24, sec. 283 sub secs 1-8].

with the result that as much Reorganization as possible under chapter 11 of the Bankruptcy code can be achieved as compared to leading European bankruptcy laws.¹⁷ In the extreme scenario, workouts are resorted to. Regarding the Bankruptcy code's orientation, literatures suggest that, in other systems, there is a move to debtor friendly bankruptcy code in line with the US bankruptcy code for instance in Germany and Netherlands.¹⁸

Relevant to the topic under consideration, the bankruptcy law effectuates workouts through some of its provisions and case laws. A system of this type, the writer believes, can be a model for emerging market economy as Ethiopia which should utilize its bankruptcy law as efficiently as possible. Workouts as party arranged device have significant role in perpetuating the business of the debtor. But this depends on the statutory or legal places given to it. In the USA as will be shown shortly, workouts, which are commended to carry strong policy of the bankruptcy code, has statutory and judicial backup.¹⁹ Ethiopia is on the process of revising its commercial code containing the bankruptcy provisions. Thus, it is necessary to evaluate if Ethiopia can adopt workouts in the forthcoming revised code.

This thesis is aimed at comparing workouts under Ethiopian and US bankruptcy laws. The thesis is divided into three chapters. The *first* chapter is devoted to general overview of workouts in Bankruptcy law. Under this chapter, issues of preliminary importance as the definition of workouts and the distinction between workouts and other related concepts such as reorganization and scheme of arrangement and, speaking under the Ethiopian law, composition are analyzed. A brief

¹⁷ *Supra* note 14 at 13.

¹⁸ *Ibid.*

¹⁹ See *Re Colonial Ford, Inc.*, 24 B.R. 1014 (Bankr. D. Utah 1982), H.R. REP. NO. 95-595 SEPT. 8, 1977, p. 294, sec. 305.

distinction between workouts and Reorganization in the context of US bankruptcy law is be dwelled upon. Moreover, the economic importance of workouts, and some of their distinctive features is treated. Equally importantly, the major drawback of workouts- Holdout Problems- is discussed.

The *second* chapter covers the legal framework pertaining to workouts in the two jurisdictions. Here, with the view to find out if workouts are regulated in anyway including contractually or, statutorily in Ethiopia, inquiry into the place of workouts under contract law and the bankruptcy code of the two systems is made. While the practical Significance of workouts including the judicial enforcement of workouts is clear in the US, the same is not true in Ethiopia. Given the fact that the Ethiopian commercial code containing the bankruptcy provisions is undergoing revision, the place of Workouts under the applicable law, with the view to making recommendations in the revised code is made. *Lastly*, the writer will make conclusions and recommendations on the role, significance, and prospect of workouts in bankruptcy in the Ethiopian system. Since this thesis is a comparative analysis of US and Ethiopian bankruptcy regimes on workouts, primary focus is made on the laws of the two jurisdictions. Nonetheless, for an insight into and awareness of existing fundamental contrasts in other systems, less frequent but necessary analysis of other laws is also made.

This thesis is aimed at bringing the concept of workouts, widely used in many developed systems exploiting it to prevent wasteful liquidation in reorganization to the attention of the professionals, practitioners, business entities, academicians and judges in Ethiopia. It is to be mentioned that due to limitations of time and access to the otherwise extremely scarce sources on bankruptcy, this thesis does not include empirical data on workouts in Ethiopia. Thus, only a theoretical framework

of the workability of workouts in Ethiopia is covered. However, an intellectual insight into the practicability of workouts is provided with – hopefully – fairly sufficient analysis.

CHAPTER ONE

Workouts: Meaning, Functions and Drawbacks: US Perspective

1. Introduction

It is noted earlier that workouts are frequently utilized in the bankruptcy law of the US. An assertion that workouts are unique to the US bankruptcy law is not warranted since it is not evident that no other bankruptcy system makes use of workouts. However, it can be fairly concluded that workouts are not common in other jurisdictions.²⁰ Thus, it naturally follows that the discussion under this chapter is adopted mainly from the US bankruptcy system. Nevertheless, for the sake of clear understanding of some concepts and providing evidences, laws of other systems are also roughly touched up on. Hence, this chapter is aimed at giving conceptual framework of workouts and their distinctive features as well as benefits. Since any discussion of workouts would be incomplete, if made in clinical separation from other bankruptcy procedures, conceptually distinguishing it from other bankruptcy procedures such as reorganization and composition is necessary. Thus, brief analysis of other bankruptcy procedures is made.

2. The definition of Workouts

Unlike other concepts in law, the definition of workouts is not one of the controversial issues in literatures. Black's Law Dictionary Defines workouts as follows;

²⁰ Cf Jhon Armour & Simon Deakin: Norms in Bankruptcy: 'A London Approach' to Resolution of Financial Distress (2000), p. 1. "The London approach" refers to debt restructuring in public companies with the same effect of workouts-prevalent in England.

“... out-of-court negotiation with creditors whereby a debtor enters into an agreement with a creditor or creditors for payment or plan to discharge the debtor’s debt.”²¹

The above definition clearly reveals the important features of workouts; that workouts are out-of-court settlement; that workouts are agreements between a debtor and creditor(s), workouts are agreement also among creditors, and workouts are aimed at discharging debt or postponing time of payment. Hence, workouts are basically contractual agreement to settle payment of debt by distressed debtor.

In the article entitled, “The Impact of State Law on Bankruptcy”, Melvin discussed Composition and Extension as out-of Court settlement.²² The following quote is relevant to the discussion here.

The oldest, the simplest, and perhaps the most satisfactory state-sanctioned technique for comprehensively resolving the insolvent debtor's difficulties with his creditors is the informal, out-of-court settlement, which may take the form of either of two common law contractual devices: the composition or the extension.²³

Melvin in the above quote, the writer believes, is referring to composition and extension as out-of-court settlement constituents of workouts. But the distinction between composition and extension lies in the fact that “composition involves an agreement that binds the parties to make and accept, respectively, a specified partial payment in full satisfaction of claims owed by the debtor to this creditor while in extension, the parties may agree only to a variation or extension of the time scheduled for payment of the assenting creditors' claims.”²⁴ Since, composition and extension are both consensual and aimed at settling the debt of court²⁵, the writer believes that

²¹Bryan A. Garner (ed.), Black's Law Dictionary (7th ed., St. Paul Minnesota, West Publishing Corporation: 1999).

²² Melvin G. Shimm, the Impact of State Law on Bankruptcy, 1971 Duke Law Journal at 881.

²³ *Ibid.*

²⁴ *Id.*, at 882

²⁵ *Ibid.*

composition and extension constitute workouts. Thus, in the US law, any reference to workouts as common law composition must be understood to mean reference to one prong of workouts-composition, which does not exclude extension for obvious reason.

3. Some Related Concepts: Composition, Reorganization, and Scheme of Arrangement

In this section, certain concepts that are relevant to workouts are discussed. This is necessitated partly because these bankruptcy procedures are alternatives to workouts or in some cases might be confusingly similar. Under the Ethiopian commercial code, no mention of Workouts *per se* is made. The code adopted liquidation, scheme of arrangement²⁶ and composition²⁷. The US Bankruptcy code adopted Liquidation and Reorganization²⁸ and gives room for enforcement of workouts. Hence, it is important first to consider the terminological differences and their origin together with their practical significances. The clear distinctions between scheme of arrangement and composition as enshrined under the Ethiopian commercial code and the legal consequences following there from are discussed later. Moreover, it is interesting to find which one is the counterpart of Reorganization and workouts under the US bankruptcy code. This discussion is reserved for later time. Below however, a brief overview of these concepts is provided.

²⁶ See Ethiopian Commercial Code, Proclamation No. 166 of 1960, Neg. Gaz. 19/3, Art. 1119 et seq.

²⁷ *Id.*, 1081 et seq.

²⁸ See PUB. L. 95-598, TITLE I, SEC. 101, NOV. 6, 1978, 92 STAT. 2549, title 11 U.S.C, Ch. 11, sec. 1101 et seq, H.R. REP. NO. 95-595 SEPT. 8, 1977, p. 294.

3.1. Composition

As shown above,²⁹ under the US law, composition is one of out-of-court settlement mechanisms utilized by a financially distressed debtor. Thus, it must be emphasized that it constitutes workouts and is therefore not separately discussed here. However, since composition has different meaning and legal significance under the Ethiopian law, this section briefly analyzes the different legal meaning of composition based on French law which has the concept of composition with Ethiopian law but different with the US law. Composition is the most closely related concept to workouts.

Black' Law Dictionary explains composition as follows;

An agreement between a debtor and two or more creditors for the adjustment or discharge of an obligation for some lesser amount; an agreement among the debtor and two or more creditors that the debtor will pay the creditors less than their full claims in full satisfaction of their claims. The preexisting-duty rule is not a defense to this type of agreement because consideration arises from the agreement by each creditor with each other to take less than full payment. Through the performance of this agreement, the debtor is discharged in full for the debts of the participating creditors.³⁰

Composition is thus a private arrangement among the debtor and creditors and the creditors themselves to the effect that the debtor pays less in full satisfaction. In this regard, composition and workouts are no different concepts. Composition is considered a terminological variance of workouts.³¹

Analysis of literatures and statutes of different jurisdictions suggest that composition is not merely a private arrangement over which the court has no control, at least in those systems.

Two factors warrant this conclusion under French bankruptcy law for instance. The first is that

²⁹ See *Supra* sec. 1.2, para 2.

³⁰ *Supra* note 24.

³¹ See *In Re Colonial Ford, Inc.*, 24 B.R. 1014 (Bankr. D. Utah 1982). One again I would like to stress that since under US law composition is one prong of workouts, courts and other authorities use the phrase "common law composition" for workouts. Moreover, it is logically clear that the parties to workouts can agree for both extension of payment and reduction of debt in which case, composition and extension are combined.

under the consolidated version of French commercial code as of March 2006, a composition procedure is instituted before the Tribunal de commerce.³² Therefore composition is not purely out-of-court settlement. Secondly, in France, Composition is a collective resolution voted upon by the creditors in which, on certain conditions, the majority vote binds the minority, who are therefore bound by an agreement to which they have not consented.³³ The same is true with the Ethiopian bankruptcy law.³⁴ In this sense, unlike the US version of workouts where there is no cramdown (imposition of consent through majority vote³⁵) on dissenting creditors, there is imposition in composition in France and Ethiopia. Hence, composition is not a mere terminological variance of workouts proper in the other jurisdictions mentioned.

But the important point is not whether composition and workouts are different concepts at least for the purpose of this thesis. Here, the fundamental concern is that workouts as out-of-court settlement are inexpensive and expeditious.³⁶ The very essence of workouts is preserved if the court has minimal intervention and freedom of the parties is maximally protected of course unless in the best interest of the debtor and the creditors requires otherwise. It follows that in order to make use of workouts effectively, workouts need to be adopted with their very essence preserved. Therefore a bankruptcy system that has put in place composition as enshrined under the French commercial code is not utilizing the benefits of workouts and in this sense; composition is not just a terminological variance of workouts but a different procedure.

³² WOLF GEORG RINGE ET AL (Eds), CURRENT ISSUES IN EUROPEAN FINANCIAL AND INSOLVENCY LAW: PERSPECTIVES FROM FRANCE AND THE UK, vol. 1(Oxford and Portland, Oregon, 2009) P. 216.

³³ *Id*, at 3 n.6.

³⁴ See *Infra* Sec. 2.3.

³⁵ Blacks Law Dictionary explains Cramdown as Court confirmation of a Chapter II bankruptcy plan despite the opposition of certain creditors.

³⁶ See *Supra* note 5.

3.2. Reorganization

Reorganization is “A financial restructuring of a corporation, esp. in the repayment of debts, under a plan created by a trustee and approved by a court.”³⁷ “Reorganization proceedings provide nothing more than a method by which the sale of an enterprise as a going concern may be made to the creditors themselves”.³⁸ Reorganization is made under the strict control and supervision of the bankruptcy court. This is the striking difference between reorganization and workouts under the US bankruptcy code.

Title 11 U.S.C. is divided into seven chapters out of which chapter 11 Reorganization, chapter 13 (adjustment of Debts of an individual with regular income) and chapter 9 (adjustment of debts of municipality) can be regarded as different forms of reorganization.³⁹ Chapter 11 Reorganization is primarily designed for corporate or business entities even though individuals or consumers may make use of it.⁴⁰ Nonetheless, since the procedure under chapter 11 is burdensome, resort to it is advised only in the business context than consumer.⁴¹ Thus, it is clear that reorganization is a different procedure established on a different rationale under the bankruptcy code.

3.3. Scheme of Arrangement

As far as scheme of arrangement is concerned, it does not exist in the US law. But, since it is one of the bankruptcy options in Ethiopia, it is discussed here for clarity. Moreover, it can be regarded as the equivalent of reorganization in the USA. “Scheme of arrangement [under] English law, is a court-approved reorganization of a company's capital structure or debts.”⁴² Under the English companies’ act 2006, scheme of arrangement allows a company, a compromise or arrangement to

³⁷ *Id.*, at 1300.

³⁸ *Supra* note 5, p. 53.

³⁹ 11 U.S.C. –Bankruptcy.

⁴⁰ H.R. REP. NO. 95-595 SEPT. 8, 1977, P. 6.

⁴¹ *Ibid.*

⁴² Bryan A. Garner (Ed), Black's Law Dictionary (9th ed., West Group, 2009), Accessed from West law data base.

be agreed between the company and its creditors or any class of them.⁴³ Under this act, Scheme of arrangement involves an initial approach to the court by the company, any creditor, member, liquidator or administrator or else summoning (with court approval) of members of the company and creditors, and initiation of the process where the court approves the initiation and after hearing objections from dissenters and considering whether the scheme is fair and reasonable, approves the agreement.⁴⁴ This short analysis of scheme of arrangement shows that it is counterpart of the US reorganization. There are certainly procedural difference in reorganization and scheme of arrangement. However, since the essence of both Reorganization and scheme of arrangement is to avoid liquidation of the company and help the company pays its debt as a going concern, it can be concluded that they are the same version of different jurisdictions.⁴⁵

From the above short discussion on Composition, reorganization and scheme of arrangement, it can be concluded that while it is clear that scheme of arrangement and reorganization are of the same essence in different jurisdictions, it is not possible to conclude that composition and workouts can be the same in different jurisdictions. Particularly the comparison of the US concept of workouts and Composition in other systems is not necessarily the same in essence. The same conclusion can be drawn with respect to composition under Ethiopian bankruptcy law and workouts in the US. Detail discussions on this point will be made later in chapter 2. In this thesis, for sake of consistency and convenience, workouts and composition are not used interchangeably. It must be noted however that most authorities, even the ones based on US bankruptcy law and practice use workouts and composition interchangeably by referring to workouts as common law

⁴³ *Supra* note 38, pp. 479-480.

⁴⁴ *Id.*, pp. 480-481, See also English Companies Act 2006, Ch. 46 Part 26, ss. 895 et seq.

⁴⁵ See also Ethiopian Commercial Code, Proclamation No. 166 of 1960, Neg. Gaz. 19/3, Art. 1119 et seq. The Ethiopian commercial code provides for scheme of arrangement which is carried out under court supervision.

composition⁴⁶, the justification for which is provided.⁴⁷ But in this thesis, such an approach will be ineffective since it is shown above that in different jurisdictions; composition carries with it different meaning and procedure as well as Lego-economic effect compared to than workouts do in the US bankruptcy law.

4. The Distinctive Feature of Workouts

Workouts carry distinctive attributes that other alternatives in and outside bankruptcy do not necessarily possess. These attributes have considerable bearing on the success and efficient utilization of workouts. Where these attributes are lacking or are not properly maintained, Workouts are no more workouts or are least likely to be efficient alternative to bankruptcy.

Firstly, workouts are private arrangements.⁴⁸ It follows from this that the parties to workouts are free to negotiate on the terms and conditions of the workouts.⁴⁹ In this regard, what limit might possibly exist on the parties' negotiating freedom, will be discussed later. Secondly, as a natural consequence of contractual freedom prevalent in workouts, workouts presuppose a consensual agreement of all the parties involved. Hence workouts require the universal agreement of all the parties involved i.e. debtor, creditors or stated negatively, there cannot be a cramdown in workouts.⁵⁰ Consequently, a nonconsenting creditor is not compelled in any way to accept term(s) in the workouts that he/she did not expressly agree to. Any class of creditor can object to the proposed workouts plan. In contrast however, a plan of reorganization separates creditors into

⁴⁶See THE NEW YORK CITY BAR ASSOCIATION, ON-BANKRUPTCY ALTERNATIVES TO RESTRUCTURINGS AND ASSET SALES (NY, Nov. 2010), p. 17-22.

⁴⁷ See *Supra* note 31.

⁴⁸ *Supra* note 46 at. 9.

⁴⁹ *Ibid.*

⁵⁰ *Id.*, at 18, n.63.

classes, usually based on the seniority of claims and under certain circumstances, the plan may imposed on particular nonconsenting class to accept proceeds equivalent to a hypothetical liquidation according to the rules of absolute priority since in reorganization, not universal consent of all the creditors, but majority, is required.⁵¹ Under the US bankruptcy code, in reorganization, if one or more of the classes of claimants or interest holders of the firm rejects the plan, the plan may still be confirmed under the cramdown provisions of Bankruptcy Code sec. 1129(b).⁵² The most important requirements of sec. 1129(b) is the absolute priority rule, which prohibits a class of claims or interests from participating in the plan unless all higher priority claimants have been paid in full.⁵³ Moreover, as established under Code sec. 1129(a) (7) a plan is not confirmed, if a creditor will not get what it would have received in Liquidation.⁵⁴ In workouts, no imposition of any kind can be made.

5. The Benefits of Workouts

Below, brief discussions of advantages of workouts over other bankruptcy options are made. Here, there are at least two bankruptcy alternatives to workouts, namely liquidation and reorganization. Liquidation being the last resort in bankruptcy that results in firm's cessation of operation⁵⁵ is the worst scenario in bankruptcy at least in the majority of the cases. Workouts do also have benefits compared to reorganization. The following paragraphs provide discussion on advantages of workouts over reorganization. The most important reason, affecting the choice of workouts over

⁵¹ *Supra* note 38, P. 458.

⁵² David Arthur Skeel, Jr. The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, Virginia Law Review, Vol. 78, No. 2 (Mar., 1992), p. 461 at 478.

⁵³ *Ibid.*

⁵⁴ *Id.*, at 494.

⁵⁵ *Supra* note 12.

bankruptcy alternatives, is the advantages of workouts. Broadly speaking workouts has three main benefits: Expeditiousness, economy and Sensibility.⁵⁶

Workouts are economic in the sense that they avoids costs related to the administration of reorganization including, creditors committee and their legal representatives expense that may ultimately affect the interest of junior creditors.⁵⁷ Among others, workouts can effectively avoid Legal and professional fees including cost of litigation, saves loss of investment opportunities and spare the smooth business relationship between the debtor and customers, all indicating that workouts are economic.⁵⁸ “For several reasons, payments for legal and other professional services are likely to be higher if a company settles its debt in bankruptcy court.”⁵⁹ Empirical data suggest that legal and professional costs are much less expensive under workouts than under chapter 11 reorganization.⁶⁰ Back in 1986 LTV Corporation, for example, has spent over \$150 million on legal and other professional fees since it filed for chapter 11 and this cost is said to ignore potentially greater costs.⁶¹ Profitable Investment opportunities may be forgone by the firm while under the prolonged procedure of reorganization.⁶² Reorganization creates substantial delays that can hamper business decision making as decisions pertaining to non-regular course of business need the approval of the court and only after notifying creditors who should file their objection.⁶³

⁵⁶ *Supra* note 11.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*, see also *supra* note 5 pp. 310-314.

⁵⁹ *Supra* note 5.

⁶⁰ *Id.*, at 311.

⁶¹ *Id.* at 308.

⁶² *Id.*, at 313.

⁶³ *Ibid.*

Moreover, bankruptcy may ruin necessary business relationship between the debtor and its various customers.⁶⁴ Firstly, the spreading of news of financial crises has prejudicial effect that Customers turn reluctant to deal with the manufacturer who may not guarantee performance of its contractual duties, and skilled managers may depart as well as there arises shift from operation of the firm to guiding the firm through bankruptcy.⁶⁵ The cost of overcoming this reluctance, through marketing campaigns and the like, may be high.⁶⁶ Sales will be difficult; prices may be low, Suppliers may dwindle, Costs of credit may increase.⁶⁷ Likewise, “accounts receivable can deteriorate to an unbelievable extent as soon as word gets around that the debtor is headed for the cemetery” a debtor doing business in Chapter 11.⁶⁸ This is an implication that workout is the best option to restructure financially distressed debtor in terms of economy.⁶⁹ Lastly, workouts are sensible because the parties to them negotiate with clear objective of settling the debt than obtaining the best deal. Hence, the parties approach each other with settlement than litigious mentality.⁷⁰

6. A Drawback in Workouts: Holdout Problem

Besides all the advantages, there is one draw back attached to workouts. The most important drawback of workouts is holdout problem. Holdout problem arises when one or more creditors behave strategically threatening to exercise Individual collection right unless other creditors make concession thereby hampering settlement.⁷¹ Here, the success of the workouts depends on whether the creditors unanimously agreed.⁷² Authorities such as Schwartz believe that holdout problems

⁶⁴ *Supra* note 5.

⁶⁵ Mark Roe, "The Voting Prohibition in Bond Workouts," 97 *Yale Law Review* (1987), p. 232, at 235.

⁶⁶ *Supra* note 5.

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

⁷⁰ *Ibid.*

⁷¹ *Supra* note 5 at 307.

⁷² *Id.*, at 316.

do prevent workouts but holdout problems are created in the context of debt contracts not by the creditors but by the distressed debtor itself through its greedy offer- an offer in workouts that gives the firm a larger and the creditors a smaller share of the firm than the bankruptcy order of distribution would.⁷³

But in any case, there are certain factors that contribute for holdout problems in workouts. Some consider that the extent of the holdout problem depends partly on what type of debt is restructured according to whom, publicly traded bonds traditionally have been restructured through voluntary exchange offers and holdout problem in these offers can be quite severe.⁷⁴ With regard to private debt, it is suggested that private restructurings is more likely to succeed.⁷⁵ Moreover, the existence of unsophisticated creditors that do not realize the value of asset in and outside litigation or multiple creditors contributes for more holdouts than where the restructuring involves bank lenders who are sophisticated or when in general there are few creditors.⁷⁶ The explanation for workouts' failure in case of multiple creditors is the differing interest of various creditors who may not be willing to accept similar terms or follow different negotiating strategies. It has been explained, parties may have different estimates of the firm's future revenue, dispersion in those estimates, institutional creditors may prefer one means of compensation such as cash or debt over the other like stock, even though managers may never provide erroneous information to the creditors, there may generally be distrust etc... all of which can lead to holdout problems.⁷⁷ Thus, due to holdout problem, the debtor might ultimately be compelled to turn to the classical bankruptcy solutions, in

⁷³ Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*: JLE, Vol. 36, No. 1, Part 2 (The Univ. of Chicago Press, April, 1993), p. 595, at 597-98.

⁷⁴ *Supra* note 36, at 316.

⁷⁵ *Id.*, at 317.

⁷⁶ *Ibid.*

⁷⁷ *Supra* note 36, at 238

which case the failed workouts would increase the cost of bankruptcy more than direct resort to bankruptcy.

In order to avoid holdout problems, it is generally recommended that the parties involved in the negotiation of the workouts need to negotiate in good faith and understanding. Finally it must be noted that with holdout problem as a drawback, the advantage of workouts, over weigh their disadvantage.

CHAPTER TWO

The Legal Framework Regulating Workouts in the US and Ethiopia

1. Introduction

In this chapter, the legal regime governing workouts in the two legal systems will be discussed. Thus, the place of workouts under contract law, bankruptcy code and practice of the US and Ethiopian system will be compared with some depth. Workouts are affected by the rules of contracts in general as they are private arrangements. This requires the analysis how workouts are treated in the context of contract law. Moreover, since workouts are peculiar to bankruptcy situations, they must have a unique connection with the bankruptcy law. In Ethiopia, workouts are not regulated in the relevant part of the commercial code of Ethiopia dealing with bankruptcy. However, it is also well known that the code has not been practiced for long time until now. Hence, it is necessary to see if the contract law is accommodative of workouts and what is the possible place of workouts under the existing bankruptcy code of Ethiopia. In this chapter, a brief analysis of the place of workouts in contracts in general and the bankruptcy law in the two jurisdictions is made. An important topic of discussion in this regard is the difference between Pre-bankruptcy contractual regime and workouts in contract the distinction of which is provided herein under. Since, analysis of the Ethiopian contract law shows that the contract law does not preclude workouts being dealt with by contract law; the critical issue of discussion in this regard is the enforceability of the workouts in the light of the rules of bankruptcy.

2. Contracts

Contract law influences workouts in many ways. However, important to the topic at hand is that not only does contract law influence workouts, but also the bankruptcy code itself. Hence, some systems have pre-default bankruptcy contract that replace the bankruptcy system. As asserted elsewhere in this thesis, workouts are contractual agreements emanating from private arrangement. An important question to be asked here however is, can a contract law regulate workouts in their entirety, without the support of the bankruptcy law, which may even claim to regulate the enforceability of the contract in the context of bankruptcy? This question is worth answering since it helps to find out if a system that has a bankruptcy code which gives no recognition to workouts can deal with workouts only through contract law regime. An important point to bear in mind in this regard is that Bankruptcy law, as it stands, is a mandatory system.⁷⁸ A debtor files for bankruptcy following pre-determined set of rules and courts do not enforce a covenant not to file for bankruptcy or to vary the existing bankruptcy rules.⁷⁹ This means that pre-default bankruptcy regime is not enforceable. This is not black and white though.

2.1. Pre-default bankruptcy contract and Workouts

There have been heated debates on whether Bankruptcy procedure should be contractualized, meaning whether creditors and debtor can set a procedure for bankruptcy before the debtor's default so that the bankruptcy code would have only gap filling role next to party autonomy.⁸⁰ Different approaches to contractualization of bankruptcy provided by their proponents - Automatic bankruptcy, Bankruptcy Menu and "evergreen regime"- are all based on the premise that privately negotiated bankruptcy regime under which all creditors, except tort creditor's(perhaps),

⁷⁸ Elizabeth Warren and Jay Lawrence, Contracting out of Bankruptcy: An Empirical Intervention, Harvard Law Review, Vol. 118, No. 4 (Feb., 2005), at 1197.

⁷⁹ *Ibid*, n.2

⁸⁰ *Id*, 1198.

will be bound by negotiation or some form of deemed acceptance, provide maximum efficiency.⁸¹ Based on empirical data however, Warren and Jay Lawrence argued convincingly that contractualization of bankruptcy would increase inefficiency, shift risk to some creditors as involuntary creditors (tort claimants), quasi- involuntary creditors (tax authorities), small claims creditors, and unsophisticated creditors.⁸² However, there are jurisdictions that allowed private pre-default negotiation of bankruptcy.⁸³ In this regard, two of the jurisdictions under comparison do not have pre-bankruptcy contractual regime.

However, workouts are not the same scenario to Pre-default bankruptcy contract of the nature dealt with in this paragraph above two paragraphs simply because workouts are dealt with after default. But a system that allows pre-default is theoretical likely to enforce workouts since if the law accommodates private bankruptcy regime, for stronger reason, it should allow private negotiation which does not even claim to contradict the bankruptcy code because in workouts, parties primarily do not go to bankruptcy in the first place. Thus, it is assumed that the workouts per se do not replace the bankruptcy law where as the Pre-default Bankruptcy contract regime is designed to substitute the bankruptcy code. Thus, a system that allows pre-bankruptcy contractual regimes compromised the mandatory law of the bankruptcy code and can be taken to be liberal as far as the application of the bankruptcy law is concerned. Thus it has far more effect in liberalizing the bankruptcy code than workouts.

⁸¹ *Id.*, 1204-1207.

⁸² *Id.*, 1253.

⁸³ See the 2009 Romanian Law concerning the Introduction of the preemptive Agreement and Ad-hoc Mandate which is officially cited as Lege nr. 381/2009 privind introducerea concordatului preventiv si mandatului ad-hoc.

2.2. Validity of Workouts in Contract

2.2.1. US Contract Law

Workouts are validly dealt with by contracts under in US both under statute and common law contract. The limitations to the enforceability of workouts are the general limits to freedom of contracts. Assuming that other requirements of contract are met by the agreement, the most important question to be asked for the enforceability of workouts in common law contracts is the doctrine of consideration. Workouts involve exchange of promise and involve consideration. “Consideration, in the sense of the law, may involve right, interest, and profit or benefit accruing to the one party or some forbearance loss, detriment or responsibility suffered or undertaken by the other party”.⁸⁴ The point where the existence of consideration in workouts may be questioned is where the workouts involve payment of money less than what is owed by the debtor. The question is that what is the debtor promising in return for the creditor’s reduction of debts, in case the creditor(s) accepts lesser payment as part of the workouts? The explanation lies in the change of the legal situation once a bankruptcy is triggered or the debtor’s or one or some of the creditor’s option to petition for bankruptcy is left as one of the alternatives following the debtor’s default. Once the debtor defaults, its legal position is changed. This means that the bankruptcy law regime comes in and is read into the existing contract. To be precise, the debtor has the option to file for liquidation and to be discharged of anything after all its asset are sold out to satisfy the debt owed to the creditors. Alternatively, one or more creditors could petition for bankruptcy. In other words, in liquidation, there is a risk that a particular creditor(s) may get nothing or get lesser than what it would get in workouts. Since, reorganization also involves greater cost; a creditor may again get lesser than what it may obtain in workouts. Hence, in workouts, where a creditor(s) gets lesser than the original debt, there is still consideration i.e. the creditor expects to get relatively more,

⁸⁴ DAVID OUGHTON & MARTIN DAVIS, SOURCE BOOK ON CONTRACT LAW (2nd Ed, 2000), P. 97.

compared to bankruptcy options. Moreover, there are also possible considerations - a wise creditor might expect- in workouts other than money including, for instance, the possibility of maintaining the debtor as a customer supplier of raw materials as a surviving entity through workouts than termination of the debtor's business operation due to liquidation or after a going concern operation following reorganization. In support of this view it is pointed out that consideration exists when a promise is made with the view to get some benefit or avoid disbenefit⁸⁵, the disbenefit avoided through workouts being the possibility that the debtor's resort to bankruptcy alternatives may result in lesser payment to creditors. Thus, workouts involve consideration and therefore are valid as contracts in common law.

In the USA contracts, the requirement of consideration as enshrined in the United States restatement to include a performance of an act other than a promise, a promise, forbearance, as well as the creation and modification of legal relations.⁸⁶ In the light of this and judicial interpretation of the doctrine of consideration⁸⁷, workouts, the author believes, fulfill the requirements of consideration and qualify as valid contract under the US contract law. Hence, workouts have been enforced by US courts without any question of enforceability on the basis of consideration.⁸⁸

⁸⁵ Id, 98.

⁸⁶ United States Restatement, Contracts (2nd), Para. 71.

⁸⁷ See *Hamer v. Sidway*, Court of Appeals NY, 1891, 124 N.Y 532. 27 NE. 256

⁸⁸ See *Supra* Note, 11 & *Infra* Note, 112.

2.2.2. Ethiopian Contract Law

Under the Ethiopian contract law,⁸⁹ a contract is an agreement that creates, varies or extinguishes an obligation of proprietary nature. Though the contract law requires a transaction involving patrimonial interest, it does not require the exchange of consideration under the general contract law provisions of the code. Thus, a contract that involves any sort of transaction in which there is patrimonial interest of the parties is valid. Viewed from the perspective of the doctrine of consideration which is not required under the Ethiopian contract law, workouts are theoretically valid contracts. Hence, theoretically speaking, Ethiopian contract law does not preclude workouts.

Under Ethiopian law, there are practical problems of enforcement of workouts, which the writer, believes, will persist for some foreseeable future. The first problem stems from the fact that the bankruptcy law of Ethiopia has not been practically tested.⁹⁰ Consequently, the connection between the bankruptcy law and other branches of law and notably the contract law has not been appreciated in practice. Thus, in few cases that arose, only the bankruptcy option is considered the sole option- viable and valid.⁹¹ Moreover, theoretically, bankruptcy involves claimants of different background that do not have the willingness to negotiate with the distressed debtor simply because of legal and practical obstacles. One of these entities is the tax authority that does not negotiate on payment of tax due to it. The existence of such entities as a bankruptcy claimant can greatly affect the mentality of not only the debtor but also other creditors that a private negotiation is simply impossibility. Up to date, the writer is not able to access any data on settlement of bankruptcy claims through workouts in Ethiopia. Nevertheless, even though the number liquidation cases are not precisely known, only few cases were handled by courts, less than ten between the year 1991-

⁸⁹ The Civil Code of Ethiopia, 1996, Proc. No. 165 Neg.Gaz, extra ordinary issue, year 19, No. 2 Art. 1675.

⁹⁰ See *Supra* note 16.

⁹¹ *Ibid*, p. 53.

2005.⁹² Creditors resort to ordinary foreclosure law which ends up with liquidation and therefore there were exceptional cases of reorganization.⁹³ This is an evidence that the time the bankruptcy law is to be applied with no deviation from any of its provisions is to be seen at least for some times and Contract law will have less place. The writer opines that the judges will be inflexible to enforce workouts under contract law in the absence of any legislative deference to it.

In conclusion, it is well established that workouts are regulated in the first place by contracts and have place in the law in the US system. It is also theoretically possible to regulate workouts by Law of contracts in Ethiopia. However, it is practically not perceivable to get enforcement of workouts without appropriate legislative back up.

2.3. The Bankruptcy code

In this section, an inquiry into the position of the US bankruptcy code and the relevant part of Ethiopia commercial code regulating bankruptcy, regarding workouts, will be critically analyzed. Since, book V of the Ethiopian commercial code⁹⁴ dealing with bankruptcy contains several less clear provisions relevant to workouts; an analysis of concepts that appear vague and susceptible to confusion with workouts is made.

2.3.1. Section 351(a) (1) US Bankruptcy Code

In the US bankruptcy code, workouts are not explicitly pointed out as one of the alternatives to the bankruptcy proceedings. However, the code has a provision giving a room for enforcement of Workouts under Sec. 305 (a) (1) which states as follows;

⁹² *Id.*

⁹³ *Id.*

⁹⁴ Commercial Code of Ethiopia, Negarit Gazzeta, Extraordinary, Proclamation No. 166(1960), Arts. 974- 1170,

“The court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if - *the interests of creditors and the debtor would be better served* by such dismissal or suspension”⁹⁵(*Emphasis added*)

Section 305(a) (1) permits the court to decline jurisdiction over the case if the interest of the creditors and the debtor is better served by the abstention.⁹⁶ One of the situations in which the interest of the debtor and the creditors is better served, requiring the court to decline jurisdiction is the existence of effectively negotiated workouts.⁹⁷ The economic justification of workouts has been provided earlier⁹⁸. However, the court must have a legal justification to decline a jurisdiction and such legal justification is the preserving of the interest of the creditors and the debtors- an explanation which is assumed in workouts in the following statement by the houses Report on section 305.

The court may dismiss or suspend the case under section [305(a) (1)], for example, if an arrangement is being worked out by creditors and the debtor out of court and there is no prejudice to the rights of the creditors in the arrangement and an involuntary case has been commenced by few recalcitrant creditors to provide a basis for future threat to extract full payment.⁹⁹

The essence of the above quote reflects the existence of legal reason to enforce workouts in that the interest of the debtor and creditors will be better served and the rights of creditors will not be prejudiced if there is an arrangement being worked out. However, as established earlier in this

⁹⁵ Sec. 305(a)(1), 11 U.S.C

⁹⁶ *Supra* note 43 P. 29. It is to be noted that section 305 there are also certain grounds different from serving the interest of the creditors on the basis of which the court may decline jurisdiction which are not relevant to the topic at hand.

⁹⁷ *Ibid.*

⁹⁸ See *Supra* sec. 1.5.

⁹⁹ H.R. REP. NO. 95-595 SEPT. 8, 1977. P. 294.

thesis, workouts need a universal agreement of all creditors and even a single creditor that is not contented with the arrangement being worked out can file involuntary petition, no matter how recalcitrant that creditor is. The mere fact of creditor's obstructive action does not warrant abstention. Thus, creditors' involuntary petition during the process of the workouts not yet finalized is not a ground for abstention where as involuntary petition after a validly and universally accepted agreement may result in abstention. Moreover, the debtor's own voluntary petition may also be challenged by creditors on the basis of workouts.¹⁰⁰ Hence, the debtor may not be convinced with the feasibility of the workouts and apply for voluntary liquidation or reorganization.¹⁰¹

Thus, in *Re Colonial Ford* case¹⁰² the District Court of Utah decided to dismiss the case under section 305(a) (1) on the basis of the existence of valid workouts. In this case, a voluntary petition for Chapter 11 reorganization was filed by the debtor, after successful workouts which have been accepted by all the creditors.¹⁰³ One of the creditors challenged the debtor's petition and requested the Court to dismiss the case on account of the workouts.¹⁰⁴ The court referred to policy choice made by the crafters of the bankruptcy code favoring workouts and reasoned that the interest of the debtor and the creditors will be better served if the petition for chapter 11 reorganization is dismissed.¹⁰⁵

¹⁰⁰ See *Supra* Note 11.

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

2.3.2. The Ethiopian Commercial Code Provisions on Bankruptcy

Under Ethiopian law, as has been established earlier in this thesis, workouts are not regulated in Book V of the commercial code. Given that the same scenario exists in the US bankruptcy code, it is not to surprising that there is no provision explicitly encouraging workouts. However, the question is whether there is a provision equivalent to section 305(a) (1) of 11 U.S.C? But before investigating into the answer for this query, a brief analysis of some of the provisions Book V is necessary. An analysis of special interest to this topic is the various options in bankruptcy other than Book V which recognize two bankruptcy alternatives in addition to Liquidation, namely; scheme of arrangement¹⁰⁶ and composition.¹⁰⁷

Scheme of arrangement is put under the code as an alternative to bankruptcy because Article 1119 commercial code 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.....”¹⁰⁸ Here, the scheme of arrangement is to be petitioned for by the debtor before its bankruptcy is declared by the court. This could be either before or after an involuntary petition for liquidation is made as bankruptcy of the debtor is declared by the court up on being convinced that the debtor is insolvent, until which moment, the debtor is legally not bankrupt.¹⁰⁹ But considering that scheme of arrangement is highly supervised by the court and the court has the power to determine whether the petition must be granted or not, it is similar to Reorganization under chapter 11 of the US

¹⁰⁶*Supra* note 27.

¹⁰⁷ Ethiopian Commercial Code, Proclamation No. 166 of 1960, Neg. Gaz. 19/3, Art. ET seq Art. 1164- 1170.

¹⁰⁸ *Id*, Art. 1119.

¹⁰⁹ *Id*, Art. 975 ET seq

bankruptcy code.¹¹⁰ Therefore, with some peculiarities, any advantages and disadvantages stemming from reorganization is applicable to scheme of arrangement.

Under Ethiopian law, composition is one of the options available to a distressed debtor. Compositions which is followed by closure of bankruptcy proceeding is treated under one chapter, viz., Book V. Title II chapter 6 settlement of Bankruptcy.¹¹¹ For several reasons, composition is not akin to workouts. Firstly, the proposal for composition need not necessarily be accepted by all creditors unanimously - the acceptance by majority of creditors suffices for the composition proposal to be enforced by the court¹¹² where as workout needs to be universally agreed up on. Secondly, the proposal for composition is made only after the debtor was declared bankrupt.¹¹³ The fact that composition is initiated after bankruptcy declaration *per se* does not necessarily make it different from Workouts since theoretically, the parties may arrange workouts after an involuntary proceeding has been started and the liquidation process is pending. But under the Ethiopian bankruptcy law, any settlement proposal submitted before the declaration of bankruptcy is not considered composition and the law is clear in this regard. Thus it does not share one thing in common with workouts at this point-that it can not be initiated unless the debtor is declared bankrupt. Thirdly, unlike workouts which are purely private arrangements and where the court does not dictate or bless their terms except on the ground of non-fulfillment of conditions set forth by general contract law, a proposal for composition is highly controlled by the court including up

¹¹⁰ The close reading of Article 1121(1) of the commercial code reveals that the scheme of arrangement proposal should contain a payment plan of at least 50 % of the debt owed to creditors in varying time periods and a personal guarantee of payment of the undertaking in the plan.

¹¹¹ *Supra* note 95.

¹¹² *Id.*, Art. 1170(1) states that a proposal for a composition shall be approved, by a majority vote of the creditors representing the majority of the debt and article 1084 specifies the vote to be two-third of majority representing two-third of the debt.

¹¹³ *Id.*, Arts 1081 cum 1046. The close consideration of these provisions reveals that the composition proposal should be submitted after the declaration of bankruptcy but before liquidation is completed.

to being subjected for the court's confirmation of the proposal.¹¹⁴ Fourthly, the composition plan, after having been confirmed by the court, must be implemented in compliance with specific instructions given by the court in its judgment confirmation.¹¹⁵ Further more, even though the confirmation of the composition has the effect of suspending the bankruptcy proceeding, the bankruptcy may be re-opened if the debtor fails to carry out terms of the composition.¹¹⁶

The above points showing the difference between workouts and composition in effect lead to the conclusion that composition under the Ethiopian bankruptcy law is not mere contractual arrangement between the debtor and the creditors but Quasi-Judicial affair carried out by the initiation of parties involved in the bankruptcy but the terms of which are highly dictated by the court. It is quasi-Judicial because the parties need to agree on certain issues but still the court has the ultimate power whether to confirm or reject the agreement. But the judicial control of it is vast since it starts first from the courtroom and ends in the courtroom. Hence, composition involves the costs involved in administration of bankruptcy considering the setting under which it is conducted. To mention some of the costs incurred, the composition involves the involvement of the bankruptcy trustee and creditors committee appointed under liquidation or scheme of arrangement thus involves fees for the respective entities involved in the administration of the composition procedure.¹¹⁷ In the light of the above points therefore, composition is not as efficient, economic and flexible as workouts.

¹¹⁴ *Id*, Art. 1087(b) declares that the court shall not confirm the composition where confirmation of the composition is contrary to the public interest or the interests of the creditors.

¹¹⁵ *Id*, Art. 1088.

¹¹⁶ *Id*, Arts. 1090, 1093 and 1094.

¹¹⁷ See *Ibid* , Art. 1082 for the power for the trustee in composition and the role of creditors' committee.

Having brief accounts of scheme of arrangement and composition and concluded that there is no a provision under the Ethiopian bankruptcy law recognizing workouts, the next question of greater significance is whether there is a provision in the code authorizing the court to suspend or dismiss bankruptcy petition similar to section 305(a) (1) 11 USC which can be exploited by courts to enforce private arrangements in bankruptcy. The answer to this query is very simple. The bankruptcy law highly taken from Swiss Bankruptcy code¹¹⁸, does not have any provision which envisages that workouts that could be utilized. Since there is no case settled by workouts that reached the court, it is not possible to be exact about the approach of the courts towards workouts. Lastly, it is necessary to consider, in presence of composition, which is very detail and purports to achieve similar purpose with workouts, if it is possible to adopting provisions regulating workouts

In this thesis, it is concluded that unlike its US counterpart, the Ethiopian bankruptcy law does not recognize workouts. More importantly however, the author strongly believes that the possibility of enforcing workouts by court of law is highly unlikely. The following reasons can be provided to that end. Firstly, the bankruptcy code is not practiced well and the significance of workouts has not been appreciated so far. Secondly, the presence of detailed provision in the code governing composition is likely to lead the court to exercise its inherent power in composition proceeding and reject any arrangement akin to composition for failure to meet the provisions regulating composition for instance payment plan which is strictly regulated by the code. Moreover, the fact that bankruptcy petition can be made not only by the creditors but also the public prosecutor¹¹⁹ makes any private arrangement before bankruptcy relatively unworkable since there is always a

¹¹⁸ *Supra* note 50, p 5.

¹¹⁹ *Supra* note 104, Art. 975.

fear and probability that the public prosecutor could intervene and petition for bankruptcy despite the pending negotiation between the debtor and creditors.

2.3.3. Workouts Specific Problem: The Effect of Debtor's Default on the Workouts

In this section, the issue of the debtor's default to carry out the terms of the workouts and its possible effects will be dealt with. The question asked can be framed as "would the debtor's default on the workouts revive the original claims of creditors or would creditors make any later claims based on the workouts term with reduced their claims?" This question has been addressed in *RE PLAZA MUSIC CO.* where the question involved was whether the creditor up on bankruptcy of the debtor followed by the debtor's failure to pay notes on workouts, can claim the original amount.¹²⁰

The answer to the above query depends on the nature of the workouts and their terms.¹²¹ Where the workouts provides for the revival of the original claims on the debtor's default, it clear that the court need not engage in determining the effect of the debtor's default as the workouts are based on freedom of contract whose terms are regulated by the parties to them.¹²² Where there is no express term in the contract regulating the issue, one scenario is when the workouts agreement merely provides for settlement of the debt with creditors who have received nothing after the settlement. In this scenario, there appears no reason to privilege the debtor who petitioned for reorganization or liquidation who never attempted to repay the debt according to the workouts, by allowing it to pay according to the new workouts' terms. Hence, in such situations, the claims of

¹²⁰ U.S.D.C., Southern District of New York 10 f. Supp. 310(1934), aff'd, 77 F.2ND1010 (2ND Cir.1935).

¹²¹ *Ibid.*

¹²² *Ibid.*

the creditors should revive. Another scenario is when the some of the creditors have been benefited and others might have suffered a detriment following the partial full or partial execution of the workouts. Here, there is no reason to benefit some creditors and leave the others in the detriment. In RE PLAZA MUSIC CO., involved the subordination of the claim of one of the creditors, where in the creditor agreed to get stock in return for which other creditors accepted payment in cash and notes of lesser amount than the original claim.¹²³ Since some creditors were partly paid according to the terms of the workouts, it is hardly possible to reinstate the subordinated creditor to its original claim. Thus, in a situations as in RE PLAZA MUSIC CO case, where the creditors agree on term in the workouts where the partial performance to one or some creditors on the workouts will put the others in an irreversible detrimental situation, the intention of the parties is that they did not intend the default of the debtor on the workouts to revive their original claims¹²⁴ This issue has already been addressed in the case under consideration. Since it is not addressed in practice in Ethiopia, courts can anticipate how to settle the issue whenever it arises.

2.4. Viability of Adopting Workouts in the New Ethiopian Bankruptcy Law

Before concluding whether workouts will be viable solution to distressed debtors in Ethiopia, the author needs to candidly admit the absence of practical data collected during the research because of absence of such data in any source. Moreover, it is noted in this thesis that the Ethiopian commercial code which regulates Bankruptcy is under going a revision. A preliminary revised draft has been reproduced by the Ethiopian Ministry of Justice (MoJ) over four years ago; it is yet to be considered to introduce some changes.¹²⁵ But a continuous attempt to access the draft law for

¹²³ *Ibid.*

¹²⁴ *Ibid.*

¹²⁵ Reporter News Paper, Saturday 16 October, 2010, accessed online on March 19, 2011 from:

analysis failed due to inaccessibility of data. Moreover, it is a fact of general knowledge that workouts are not topical in the current socio-economic setting among the professionals and in the Academia. This may lead to the question whether workouts that are utilized in the US because of the developed economy and business can be utilized in Ethiopia. Can any reasoning lead to the conclusion that it is not so important for an emerging economy like Ethiopia? The writer believes that this question would be legitimate and sensible but undemanding to answer. The beauty of workouts exists in the fact that they help business to survive and help the economy grow, if utilized properly.

One can summarize the reasons to adopt workouts as viable solution in Ethiopia as follows. Just like in any system, Litigation is very expensive affair in Ethiopia. Thus to the extent possible, it must be avoided. Moreover, the bankruptcy proceedings - Liquidation, scheme of arrangement and composition are costly as has been demonstrated earlier. One of the reasons for the impracticability of the bankruptcy law up to date is the fact that it is expensive to resort to bankruptcy due to the involvement of the court, the bankruptcy trustee, the commissioner, and the creditors' committee in the bankruptcy proceeding.¹²⁶ Hence, lenders are relying on foreclosure laws. By using foreclosure law and mandatory financial managers, creditors bypass bankruptcy. However, for the past several years, this has not necessarily been negative.¹²⁷ Mainly, the creditor-debtor relationship has not been sophisticated as it involved one creditor (usually the commercial bank) that often uses the safety provisions of business pledge and put in a financial manager in the

http://www.ethiopianreporter.com/english/index.php?option=com_content&view=article&id=1241:business-community-pushes-for-revision-of-commercial-code&catid=100:business-and-economy&Itemid=517#

¹²⁶ Cf MENBERETSEHAI TADESSE, COMMERCIAL ENFORCEMENT AND INLOVENCY SYSTEMS: ETHIOPIA (Malibu, 2003), p, 8-9. This document briefs the entities involved in the administration of bankruptcy proceedings.

¹²⁷ *Supra* note 12, p. 56.

management of the troubled debtor.¹²⁸ When any attempt of the debtor's operation fails, the creditor resorts to foreclosure law.¹²⁹ Consequently, for lenders, the necessity of resorting to bankruptcy was not the best option. But through time, the economy progresses and the debtor creditor relationships becomes sophisticated with the need to get more access to credit. Hence, the ordinary foreclosure law will definitely not help because of possible conflicting claims on the debtor's asset or business. This would necessarily push the creditors to use the bankruptcy as one of the option. It is at this point that the practical need to restructure debts outside bankruptcy which is found as the viable solution will be felt. Another reason perhaps preventing resort to bankruptcy is that most companies have been state owned¹³⁰ and going bankrupt for state owned corporations is not a usually common scenario. However, recently, privately owned companies emerge rapidly that would inevitably use the bankruptcy law. Hence, the writer believes that in the new commercial code should give express recognition to workouts and they will be viable. After all, there is no cost in having in the law, if there is no cost in having a bankruptcy law which is hardly applied in practice for at least half a century.

¹²⁸ *Ibid.*

¹²⁹ *Ibid.*

¹³⁰ *Cf* Fekadu Petros Gebremeskel, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Consideration (MIZAN LAW REVIEW Vol. 4 No.1, March 2010), p. 8

CONCLUSION AND RECOMMANDATIONS

It has been discussed in thesis that workouts as alternative to bankruptcy solutions are efficient, economic, flexible and sensible to restructure a debt of distressed firm. In order to avoid, various costs involved in bankruptcy procedures including, legal and professional fees and loss of business or investment opportunities, workouts are used most often in the USA.

The comparison of US and Ethiopian Bankruptcy law reveals that there is no recognition of workouts under the Ethiopian Bankruptcy law while it is well established under the US bankruptcy code and case law. As for the modality of recognition, the US bankruptcy code does not make explicit reference to workouts. It only gives effect to workouts through section 305(a)(1) rule of abstention which requires the court to dismiss a petition for bankruptcy when the interest of creditors and the debtor will be better served by the dismissal or suspension. It is shown that one of the grounds for dismissal is the existence of effectively negotiated workouts. In the Ethiopian counterpart, there is no equivalent provision in the relevant part of the commercial code through which workouts can be enforced.

As workouts are private arrangements, the possibility of regulating workouts through contract law in Ethiopia is discussed and the result is affirmative. However, for a number of reasons, it is nearly impossible to enforce contracts dealing with debt restructuring when the debtor actually defaulted in paying his creditors. Thus, in the absence of legislative deference to workouts, it is practically difficult to regulate workouts through ordinary contract law. No practical data of workouts is available so far. Therefore, it is not possible to speak concretely of the practice. However, given

the fact that only few cases arose under book V of the commercial code, it can be concluded that no failed workouts reached the court.

In the light of the above discussions, the writer recommends the adoption provision in the new commercial code regulating workouts. Since certain issues that are not settled in the US bankruptcy code, which however were settled by courts in practice might arise, the Ethiopian legislature should adopt certain detailed provisions. One of such issues includes the effect of workouts on which the debtor defaulted. This issue was settled in case law in the US system. However, since Ethiopia is a civil law country where the courts apply solely the law, issues that are not totally settled in the law might be of severe consequence in the legal system. Therefore, the new bankruptcy law should address in what situations, the default of the debtor may result in the revival of creditor's original claims. Moreover, it should set general rules of interpreting the parties' intention in such situations. Further, the provisions of the code relating to composition appear redundant in the presence of liquidation and Scheme of arrangement. It is however to be hasty to conclude, without further research that, the provisions of the code governing composition are not important at all. For this, a different piece of research needs to be conducted. However, since workouts in essence are different from compositions, Ethiopian courts should clearly distinguish between the two and enforce workouts without their essence being affected, whenever the chance arises.

BIBLIOGRAPHY

Books

1. ANDREW R.REAY & PETER WALTON, SOLVENCY LAW: PERSONAL AND CORPORATE (Jordan Publishing Ltd, 2d ed 2008)
2. VANESSA FINCH; CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES(2d Ed), Cambridge Univ. Press(2009)
3. MERTON H. MILLER ET AL, CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES (Jagdeep S. Bhandari & Lawrence A. Weiss eds, Cambridge Univ. Press 1996)
4. Bryan A. Garner (ed), Black's Law Dictionary (7th ed., St. Paul Minnesota, West Publishing Corporation: 1999)
5. PHILIPPE THÉRY ET AL, CURRENT ISSUES IN EUROPEAN FINANCIAL AND INSOLVENCY LAW PERSPECTIVES FROM FRANCE AND THE UK(Wolf-Georg Ringe ET AL eds, Oxford & Portland, 2009)
6. WILLIAM L. NORTON, JR., Norton Bankruptcy Law and Practice(3d)
7. WOLF GEORG RINGE ET AL(Eds), CURRENT ISSUES IN EUROPEAN FINANCIAL AND INSOLVENCY LAW: PERSPECTIVES FROM FRANCE AND THE UK(vol. 11Oxford and Portland, Oregon 2009)
8. THE NEW YORK CITY BAR ASSOCIATION, NON-BANKRUPTCY ALTERNATIVES TO RESTRUCTURINGS AND ASSET SALES (NY, Nov. 2010)
9. Kenneth W. Dam, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT, Brookings Institution press(2006), Washington D.C

10. USAID, ETHIOPIAN COMMERCIAL LAW & INSTITUTIONAL REFORM AND TRADE DIAGNOSTIC(Jan 2007)
11. DAVID OUGHTON & MARTIN DAVIS. SOURCE BOOK ON CONTRACT LAW(2ND ED.), 2000,
12. MENBERETSEHAI TADESSE, COMMERCIAL ENFORCEMENT AND INLOVENCY SYSTEMS: ETHIOPIA (Malibu 2003),

Articles

1. Salvatore Mancuso, The New African Law: Beyond the Difference between Common Law and Civil Law, Annual survey of International & Comparative law (Vol. 14, Issue 1. Article 4)
2. Paul Brietzke, Private Law in Ethiopia, JAL, Vol. 18, No. 2 (Autumn, 1974), pp. 149-167,Cambridge Univ. Press on behalf of the School of Oriental and African Studies Stable)
3. Maria Brouwer, Reorganization in US and European Bankruptcy law, Eur J Law Econ (2006)
4. Sandra E. Mayerson, Current Developments in Prepacked Bankruptcy Plan, Practicing Law Institute(2002)
5. Legislation, *Compositions and Extensions under the Recent Bankruptcy Amendments*, Columbia Law Review, Vol. 33, No. 4 (Apr., 1933), pp. 704-722, avaialble on: Stable URL: <http://www.jstor.org/stable/1115493>
6. Theodore Eisenberg, Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining, Virginia Law Review, Vol. 75, No. 2, Symposium on the Law and Economics ofBargaining (Mar., 1989), pp. 205-218
7. Volkmar Gessner ET AL, Three Functions of Bankruptcy Law: The West German Case, Law & Society Review, Vol. 12, No. 4 (Summer, 1978), pp. 499-544

8. Sris Chatterjee ET AL, Resolution of Financial Distress: Debt Restructurings via Chapter 11, Prepackaged Bankruptcies, and Workouts: Financial Management, Vol. 25, No. 1 (Spring, 1996), pp. 5-18, Blackwell Publishing on behalf of the Financial Management Association
9. David Arthur Skeel, Jr. The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, Virginia Law Review, Vol. 78, No. 2 (Mar., 1992), pp. 461-533 Accessed from Jstor at Stable URL: <http://www.jstor.org/stable/1073367>
10. Alan Schwartz, Bankruptcy Workouts and Debt Contracts : JL E, Vol. 36, No. 1, Part 2, The Univ. of Chicago Press (Apr., 1993), pp. 595-632, Accessible at: Stable URL: <http://www.jstor.org/stable/725492>
11. Mark Roe, "The Voting Prohibition in Bond Workouts," 97 *Yale Law Review* (1987), p. 232
12. Sris Chatterjee Et Al, Resolution of Financial Distress: Debt Restructuring Via Chapter 11, Prepaid Bankruptcies and Workouts, Financial management, Vol. 25, No. 1, 1996 at 5
13. Elizabeth Warren and Jay Lawrence, Contracting out of Bankruptcy: An Empirical Intervention, Harvard Law Review, Vol. 118, No. 4 (Feb., 2005), pp. 1197-1254
14. Melvin G. Shimm, the Impact of State Law on Bankruptcy, 1971 Duke Law Journal, pp. 879-912.
15. Jhon Armour & Simon Deakin: Norms in Bankruptcy: ‘A London Approach’ to Resolution of Financial Distress (2000)

Legal Sources

Statutes

1. Legal Notice No. 42, Federal Democratic Republic of Ethiopia, Federal Negarit Gazette, Proclamation No. 454/2005: A proclamation to amend Federal courts Proclamation No. 25/96

2. German Criminal code (Strafgesetzbuch), promulgated on 13 November 1998 (Federal Law Gazette I, p. 945, p. 3322)
3. 11 U.S.C-Bankruptcy: accessible at: http://www.law.cornell.edu/uscode/usc_sup_01_11.html
4. Commercial Code, Proclamation No. 166 of 1960, Neg. Gaz. 19/3.

Cases

1. Re Colonial Ford, Inc., 24 B.R. 1014 (Bankr. D. Utah 1982)
2. Hamer v. Sideway, Court of Appeals NY, 1891, 124 N.Y 532. 27 NE. 256
3. U.S.D.C., Southern District of New York 10 f. Supp. 310(1934), aff'd, 77 F.2ND1010 (2ND Cir.1935).

Others

1. H.R. REP. NO. 95-595 SEPT. 8, 1977