Designing an Effective and Efficient Insolvency Code For a Tanzanian Market Economy

*Isaya J Jairo**

Abstract: During government ownership public corporations dominated the economy and some used to be subsidised and kept going even when they were technically bankrupt. Given that situation the insolvency code was not playing its role and its shortcomings could not be detected. Bankruptcy laws have a major impact on lender-borrower relationships and therefore on the structure of ownership and capital in companies.

Investors take into account the fact that the design and the direct and indirect costs of a bankruptcy process differ among countries. These aspects of the code influence borrowing and lending decisions. This paper reviews the Tanzania insolvency and related legislation, comparing their efficiency against a number of benchmarks. The benchmarks are a result of a study of eight insolvency codes those of UK, US, France, Germany, Italy, Canada, Japan and Sweden. UK was the source of Tanzanian code.

Other codes have been selected because they cover a broad spectrum of the competing debtor-and creditor-oriented insolvency procedures. The Swedish auction bankruptcy system provides a peculiar additional alternative. The paper discusses the spirit behind different codes and explores economic and financial implications for adopting a particular alternative, before making suggestions on how to come up with an effective and efficient bankruptcy law.

INTRODUCTION

There has been a wide attention to the role of corporate debt finance policy and bankruptcy in finance literature in western economies. However, little has been explored about the influence of insolvency codes on financing decisions, which could have impact on third world economies. The purpose of this study is to synthesize the existing literature on bankruptcy law, reorganization and liquidation in relation to the current economic environment in the third world and particularly Africa.

In East Africa there has been a lot of plans for legal reforms, and for a long time Tanzania has had a (permanent) Law Reform Commission. Recently Uganda vowed to amend 44 colonial laws, which they say inhibit transactions and promote corruption. These Ugandan colonial laws range from, Land law, to Insolvency law. Some of the bills like the one on Company law have already been prepared. Of more interest to this paper is the Insolvency law, which Ugandans argue was not being enforced and made it difficult for the economy to grow. According to Uganda Investment Authority, insolvent companies were not declared bankrupt; they continued to borrow money as they operate, in the process draining the economy (See The EastAfrican January 14th 2002). It sounds like there is also a problem in the application of those laws. While the rest of this paper may be relevant for all East African countries, it focuses particularly on Tanzania, a country that inherited and continues to use many colonial laws including those relating to business insolvency.

Bankruptcy:[1] Terminologies and Process

Defining some terminology is necessary before we can be able to proceed. The *Oxford English*

* Senior Lecturer in Accounting and Finance, Institute of Finance and Management (IFM), Dar es Salaam.

[1] In the US, bankruptcy refers to corporate insolvency whereas in the UK the tenD is only applied to individual insolvency. In Tanzania, due to the fact that its codes were inherited from British colonial system the tenD is used as it is used in the UK

Dictionary (1999) defines the word insolvent as a situation where "the debtor is unable to pay hisdebts" and liquidation is defined by that dictionary as to "close down (a business) and divide its assets among creditors." The *Concise Oxford Dictionary* defines bankruptcy to include "being in the legal process because of insolvency," and liquidation as "to have the affairs of a company wound up." The two dictionaries define a receiver as an official (appointed by court's receiving order) to administer property of a bankrupt person or company. A company is said to be under receivership when it is being dealt with by a receiver.

It is important to note that not all companies which pass through receivership, are wound up or liquidated. Sometimes, as it will be discussed in subsequent sections, financially distressed firms go through a bankruptcy process simply to alter their ownership structure (and other features) and emerge healthy to continue with business. This is what is referred to as 'reorganization.' Although not exactly the same, reorganization may be similar to the current divesture process, being carried out by the Presidential Parastatal Sector Reform Commission (PSRC). Bankruptcy laws and procedures date back centuries in the developed world. *The Economist* (February 24, 1990) provides a clue about the origins of modem bankruptcy:

> The word bankruptcy comes from banca rotta, Italian for broken bench. The custom was that when a medieval trader failed to pay his creditors his trading bench was broken. Since bankruptcy was taken off the streets 'and put into the statute book it has become rather complicated....England's first bankruptcy law, signed by Henry VIII in 1542, was an "Act against such persons as do make bankrupt." For centuries British bankrupts went to debtor's prison: Charles Lamb, an essayist, thought they should be hanged...In contrast, one of America's attractions to immigrants was its very lack of a debtor's prison. Bankruptcy is still viewed in America as a side-effect of entrepreneurship.' (Quoted from Senbet and Seward, 1995, p. 925).

In this paper, while we will try to be as close as possible to the dictionary definitions, unless specifically stated, we will tend to use the terms bankruptcy and insolvency interchangeably and we also focus mainly on insolvency of companies not of individuals or partnerships.

Why is this Study Important?

During government ownership public corporations dominated the economy and they used to be subsidised and kept going even when they were technically bankrupt. Given that situation the insolvency code was not playing its role and its shortcomings could not be detected. Now that most of companies are going to be privately owned with no possibility of subsidisation, the weaknesses of Tanzania's insolvency code will be revealed.As a result of restructuring process and in order to lure investors, Tanzania has no choice but to carryout various forms of legal reforms. In the process legislators need to take into account the operations of an emerging market economy. This will invq!Ye the revision of insolvency code and procedures to determine if its provisions provide the correct incentives to liquidate or maintain an insolvent company as a going concern. This study contributes to that revision.

Investors in the privatised companies and stakeholders need to know potential rights and obligations in the event of bankruptcy. Employees are equally interested to know what is likely to befall them. It is here where there is need for analysis of strengths and weaknesses of competing creditor- and debtor-oriented bankruptcy laws currently practiced in western market economies. Many foreign and multinational investors have shown interest in Tanzania. One of the reasons being that emerging markets are likely to generate higher returns than what their investments generate in the developed economies. Proponents of this view argue that there is a negative correlation between the returns of developed markets and those of emerging markets due to the fact that the markets are

affected by different factors. In order to lure these investors, there is a need for a second look into insolvency law.

Bankruptcy laws have a major impact on lender-borrower relationships and therefore on the structure of ownership and capital in private companies. Investors currently buying companies or investing in Africa take into account the fact that the design, and the direct and indirect costs of a bankruptcy process differ among countries. This means that insolvency laws are likely to influence borrowing and lending decisions (Kaiser, 1996). As the international market place continues to integrate, the importance of uniform bankruptcy laws also increases. There may also be a need for economic integrations such as Southern African Development Coordination Conference (SADCC), East African Community (EAC), and even COMESA, to think of appropriate procedures if they wish to harmonize insolvency codes.

The Need for Bankruptcy Law

It is worthwhile exploring what is the importance of bankruptcy law. In fact some scholars have even questioned whether a bankruptcy code is needed at all. They have argued that such a code limits the contracts that can be written between creditors and debtors and it is debatable whether this is desirable (Franks et ai, 1996). However, (lack of any form of regulation in the light of market failures (Jairo, 1994), and the aftermath of the recent bankruptcy of Enron, which was in favour of deregulation, points towards the need for some form of regulation. It has been documented that the role of bankruptcy law is to:

> ....Provide a framework to permit viable but liquidity constrained firms (those which can be reasonably expected to earn at least their cost of capital if continued but which are presently unable to meet their financial obligations) to reorganize and continue doing business and nonviable firms to be liquidated (Kaiser, 1996,67).

Although this seems to be the ideal role, some bankruptcy codes focus more on ensuring the continued operation of firms thought to be viable, some concentrate on enforcing credit contracts by making sure that claims are paid following the absolute priority rule. Others are aiming at preservation of employment, while the remaining ones seem to be more inclined to speed up the liquidation of nonviable firms.

Bankruptcy Law and the Theory of Capital Structure

It has been argued that the design of a bankruptcy code may influence the nature and size of costs incurred during a bankruptcy process. Bankruptcy costs comprise of legal, accounting and other administrative costs, and indirect costs which are costs such as lost investment opportunities, and over or under investment. This argument led to another argument that potential bankruptcy costs have influence on capital structure decisions. That although the use of debt finance is advantageous due to corporate tax benefits arising from interest deductibility, the excessive reliance on debt may prompt bankruptcy. The search for an optimal capital structure started.

By 1970, the general view was that an optimal capital structure existed. This view was that this optimal level could be achieved by striking a balance between the corporate tax advantages of debt against the present value of financial distress costs. Brealey and Myers, (2000) call this view "trade off" theory of capital structure. Capital structure theory is complex and has a number of inconclusive ideas.

The foregoing discussion implies that the way a bankruptcy law is designed could influence not only how managers make financing decisions, but also the decision by lenders (e.g. banks) to lend in a given jurisdiction. While we leave that area for later research, this paper looks at the design of an efficient bankruptcy law. The paper does not attempt to prescribe how to draught the statutes, rather the paper looks at the spirit behind the law and is written from the point of view of a

finance scholar by discussing the spirit behind different codes and exploring economic and financial implications for adopting a particular alternative, before making suggestions on how to come up with an effective and efficient bankruptcy law. Section II of the paper briefly describes the Tanzanian bankruptcy law and procedures. Section III looks at Insolvency codes of other eight countries. In section IV an assessment of the effectiveness and efficiency of an insolvency code is made. Section V comes up with the guidelines on how to design an efficient code. Then section VI summarises and concludes.

TANZANIA'S BANKRUPTCY LAWS

In Tanzania, legal provisions governing bankruptcy/insolvency are in a number of laws. Bankruptcy of individuals and partnerships is governed by The Bankruptcy ordinance, Cap 25. Winding ups, and liquidation of companies registered under the Companies Ordinance, cap 212 (of 1932), are governed by the statutory process outlined in the same company law. Specific provisions are given in sections 163 to 220 and sections 257 to 285. Some of the provisions of the Bankruptcy Ordinance (Cap. 25) are also applicable to companies brought into existence by the Company Law.

Receiverships are governed by the then Conveyancing Act, 1881 of the UK. Its application having been secured by the Judicature and the Application of Laws Ordinance, Cap 453. Interestingly however, the Conveyancing Act is still applicable in Tanzania despite the fact that in the UK the law of Property Act, 1925, has replaced it. This is but just one example of a number of the so called "English Laws" which Tanzania still retains in its statute books while England has 'scrapped or changed' them to suit the changing business environment. Sections 286 to 291 of the Companies Ordinance also govern appointment of Receivers in respect of companies.

The Tanzania's Companies Ordinance was a copy of the 1929 Companies Act of the UK (Briston and Wallace, (1990". The UK has since then re-enacted or made major changes in their company law several times, the major ones being in 1948, 1985, and recently, in 1989.

Winding up of public corporations depends on how the corporation in question came into existence. To wind up a corporation set up by a special Act of Parliament, another special Act is necessary. An example here is the State Trading Corporation (Dissolution) Act, 1973 (Benedict, 1984). For those established by a Presidential Order, under..the then Public Corporations Act, 1969 and its subsequent amendments, another presidential Order would be needed. There are also other Public Corporations 'Parastatals' which were incorporated under the Companies Ordinance, Cap 212. The winding up of these are according to the provisions of that Ordinance, which have been highlighted in preceding paragraphs. Examples here include the then National Textile Corporation and National Road Haulage Limited. Under section 331 (d) and (e) of the Companies Ordinance (Amendment) Act, 1975, the President has powers to order a winding up or to order a company to cease to carryon business in the country.

It is important to note that the colonial laws that were inherited from colonial masters were put in place by them to suit the state controlled colonial economy and not a market economy which developing countries are now trying to build. Despite the liberalization of our economy since 1980s the legal framework has not been reformed. No wonder some studies show that these archaic laws hamper industrial progress (Business Times, December 7th 2001). While we leave others to study and make suggestions on how to change other identified problematic commercial or economic laws, this paper focuses on laws relating to bankruptcy and insolvency.

For a long time the Tanzanian government had subsidized public corporations. It is only recently

that the government decided to leave those unviable corporations to die and to restructure those, which are thought to be viable. As it is the intention of the government to withdraw from the production and distribution of goods and services, it means that after restructuring, unprofitable companies will be dying a natural death. Death or bankruptcy of companies has impacts on the economy. There is also a possibility that some unscrupulous management may take advantage of lack of appropriate legal framework to rip off the country or employees and abandon their companies. There is a need for regulation of bankruptcy, which reflects existing environment.

It is against this background that this study is arguing for (1) an overhaul of the bankruptcy, receivership and liquidation procedures in Tanzania, and (2) establishment of an efficient code which will match the current economic environment. The remaining part of the paper however, dwells much on the establishment of an efficient insolvency code.

BANKRUPTCY PROCEDURES IN TANZANIA

Although our main intention is to discuss bankruptcy of companies, it is necessary first to highlight some provisions of bankruptcy of individuals because, as we will see later, there are interconnections between the two. The Bankruptcy Ordinance, Cap 25, together with the rules made under section 121 of that Ordinance, governs bankruptcy of individuals in Tanzania. Cap 25 defines insolvency as a position were a person finds himself unable to unable to pay his debts as and when they fall due, and sections 29 (3) (c) and 137 (1) (r) makes it an offence for a person to continue trading after having realised .his insolvency.

The bankruptcy process against an individual is triggered by the 'act of bankruptcy' committed by that individual. On the basis of that act, the petition for bankruptcy is to be filed either by the same person or by his creditor(s) who are competent to do so. The court then issues a receiving order and appoints an official receiver to whom the property of the 'bankrupt' is transferred for protection from improper dispositions. Other administrative and accounting procedures follow until an Adjudication Order declares the person bankrupt and later the person is 'discharged' form all debts 'provable in bankruptcy' (S. 14 to 29 of the Bankruptcy Ordinance). After the determination of the value of the property of the bankrupt and after all the claims have been 'proved', the property is sold and the proceeds distributed according to absolute priority rules.

Liquidation of Companies

There are two types of winding up: voluntary winding up and compulsory winding up. In a voluntary winding up directors make a "declaration of solvency" and the incumbent management remain in overall control. The process becomes a members' voluntary winding up. In case the directors are unable to make the declaration that the company will be able to pay its debts in full, the process of winding up becomes a creditors voluntary winding up. In which case creditors meet and may appoint a liquidator. Where fraud or irregularity is suspected, any creditor or any member may apply to court and the court may then order a voluntary winding up under the supervision of court.

Compulsory winding up is by order of the court. This is provided for under sections 163 to 220 of the Companies Ordinance, Cap 212. Section 348 (1) of this Ordinance has also made the Companies (Winding Up) Rules, 1929 of UK applicable to Tanzania "as construed by the courts to apply to local circumstances and to the extent not inconsistent with the Companies Ordinance". The company, a creditor or, a contributory, may make the petition for a winding up order, and that marks the commencement of winding up. Following that, the court appoints a provisional liquidator to act as a custodian of the company's properties. The court may appoint a special

manager to exercise direct control and management of the company. After the court has made a winding up order, all powers of the directors cease. All the servants of the company are discharged, though they can prove for damages, and may be re-employed by the liquidator. However, compensation for servants who have been re-employed is not preferential since under section 26 of Workers Compensation ordinance, (Cap 263 of 1949), in the case of bankruptcies, only where the amount has accrued due before the commencement of winding up then it can be preferential.

Absolute Priority Rules (APR)

In the distribution of property, the liquidator is required to settle claims according to absolute priority rules (APR) in the following order: costs and expenses, liquidator's remuneration, preferential creditors, creditors with a floating charge on the assets.Next are unsecured creditors, deferred creditors, Preference shareholders and lastly Other Shareholders. Section 258 of the Companies Ordinance makes all provisions of the Bankruptcy Ordinance, Cap 25, in respect of, rights of secured and unsecured creditors, debts provable against the estate, and valuation of annuities, future and contingent liabilities, also applicable to winding up of companies. It should be noted that these applications should be made with some modifications.

Receiverships

It was mentioned earlier that in Tanzania Receivers are appointed and governed by the then Conveyancing Act, 1881 of the UK. The application of this UK law having been secured by the Judicature and the Application of Laws Ordinance, Cap 453. The fact that this law is still applicable in Tanzania even after the UK has replaced it by the law of Property Act, 1925, is yet another reason for the enactment of new efficient and constructive laws. A receiver is appointed either by making an application to the court, or outside court by creditor has a charge (fixed or floating) over a property, on the basis of the power vested in them under the security creating the charge (e.g.) a debenture). In cases were the Receiver is also required to carry on the business of the company, he is known as a Receiver manager.

CODES IN OTHER JURISDICTIONS

International comparative analysis of bankruptcy laws and practices is a difficult task. This difficulty is exacerbated by the fact that in some cases the same terminology may mean a different thing in another country. Appendix 1 summarizes central characteristics of the legal rules under the eight bankruptcy jurisdictions investigated in this study. A brief description of some of the codes listed therin is provided below:

UK Insolvency Code

Prior to the 1986 Insolvency Act there were three possible routes for a financially distressed company: liquidation, receivership and company voluntary arrangements (CV A), and liquidation (Franks et ai, 1996). After the Insolvency Act of 1986limited companies have access to the following routes: receivership, administrative receivership, administration, company voluntary arrangements (CV A), arrangements under the Companies Act, 1985, and liquidation (Kaiser, 1996).

Receiverships

Receivership occurs when the holder of a fixed charge appoints a receiver whose task is to realize the asset securing the fixed charge and distributes the proceeds to the security holder. The receiver does not take control of the firm. Although it does not prevent reorganization, receiverships usually result in a prompt sale; only 22% of reorganizations are accounted for by receiverships (Rajak, 1994).

Administration Receivership

This is the method by which holders of floating charges enforce their security by appointing an administrative receiver who assumes control of the entire firm in order to realise sufficient value from the assets of the firm to repay the floating claims. The administrative receiver normally discharges employees before sale and the buyer may re-employ them.

Administration

Directors, who are required to propose plan within three months, initiate administrations. Approval is given only when there is a good chance of the firm emerging as a going concern. Administration aims at providing firms without floating claim holders, access to an administrator with powers similar to those enjoyed by the administrative receiver. However this alternative is rarely used compared to receiverships or liquidation.

Company Voluntary Arrangements (CV A)

These are initiated by directors petition and were intended to be used by viable firms to restructure their financial obligations. This option is most effective when used jointly with administration, which is what usually happens. Approval of the scheme requires 75% in attendance or voting by proxy in favour. However, under CV A there is no automatic stay.

Arrangements Under the Companies Act, 1985

These were introduced to provide an alternative to liquidation. However, the newer procedures of administration and CV A (introduced in 1986) render this route unattractive. These arrangements require acceptance by 75% in value of each class of creditors and shareholders, hence may only be more appropriate for firms with highly complicated financial structure, making approval at a single meeting of creditors difficult (Kaiser, 1996).

Liquidation

This is so far the most widely used route and account for about 75% of all formal insolvency proceedings (Rajack, 1994; Olsen, 1996). The objective of the liquidator is to sell sufficient of the firm's assets to repay creditors, although he can also sell the company as a goIng concern.

In all UK's insolvency procedures, control of the company is transferred from the incumbent management to a "licensed insolvency practitioner", usually a professional accountant or an accounting firm (Kaiser, 1996). The relative advantages of UK's reorganization procedures include the existence of automatic stay in administration, the possibility of exchanging existing securities for new ones, simple voting procedures under the Insolvency Act of 1986, and the possibility of obtaining new financing. These imply that it is likely that a firm will be nursed and become healthy or being sold as a going concern.

The general view however is that drawbacks outweigh benefits. First, the removal of management negatively impacts the value and viability of the business. The opportunity for financing is not as developed, as it will be seen below under US's Chapter 11. All in all UK insolvency law is creditor oriented. Another problem associated with this set up is that managers and employees loose jobs, and equity holders get nothing in case of financial distress. Managers therefore have incentives to delay the formal filing and do so when the firms have reached an alarming stage of distress. This minimises chances of a successful reorganization (See Kaiser, (1996), and Franks et al, (1996)).

US BANKRUPTCY CODE

The US Bankruptcy Reform Act, of 1978 was criticised and subsequently reformed in 1994. The current formal bankruptcy proceedings entail two alternative routes: a liquidation process (Chapter 7), whose provisions are intended to implement a quick and efficient liquidation. Following a firm

shut down by a court-appointed trustee, the liquidation proceeds are distributed in accordance with the absolute priority rule (APR). The second route (Chapter 11) is intended to encourage and facilitate the reorganization of a financially distressed firm, and the incumbent management remain in charge and plays a crucial role in the reorganization process.

While all the European codes discussed in this paper have been revised in the past twenty years, none permit the debtor (distressed company) such powers as that given to the debtor in Chapter 11. The rationale is that existing management representing shareholders will have greater incentives to maintain the firm as a going concern in order to preserve some value for equity claims (Franks, et al (1996); Gilson (1989)).

Most firms enter Chapter 11 after attempting "workouts" which involve lower direct costs, as time spent is shorter, 17 months against 27 months in Chapter 11 (Franks and Torous, 1994). Prepackaged bankruptcy or "Prepacks" are also used in order to forestall future litigation and take the tax benefit of Chapter 11 (Franks et ai, 1996). Workouts are private (out of court) agreements between the debtor and creditors, while prepacks are basically workouts which are submitted to the court for approval so as to avoid potential future litigation by any party. The US code is a predominantly debtor-oriented.

THE GERMANY CODE

The code provided for two forms court of proceedings, composition proceedings (*Vergleichsordnung*), and Compulsory liquidation (*Konkursordnung*). This German It code gave more rights to secured creditors hence a possibility of premature liquidation. New code passed in 1994, which came into effect in 1999, mitigates these effects by introducing automatic stay and diluting secured creditors rights through majority voting procedures. There is also a composition procedure incorporated into bankruptcy status, Zwangsvergleich, which is similar to out-of-court composition. Although composition was intended to reorganize a firm, it is extremely rare for firms to survive through either route. This makes most firms to opt for out-of-court workout (Franks *et al*, 1996).

FRENCH CODE

Of the European nations, France has gone the furthest toward providing opportunities for reorganizing a distressed firm. The 1985 law and also the 1994 revision state that the objectives of the law, in order of priority, are (1) to maintain the firm's operations (2) to preserve employment, and (3) to enforce credit contracts. The main outcome of 1994 revision was to shift (modestly) some balance of power back to creditors.

Three alternatives exist: Prior to ceasing payments on its debts a firm can use the negotiated settlement (reglement amiable) to restructure its liabilities. The debtor petitions, then remains in control and negotiates with creditors. After having ceased payments a firm enters judicial arrangement (redressement judiciare), which can also be filed by creditors and commercial court. An 'observation stage' of between eight to eighteen months is allowed for parties to consider a reorganization option.

Should the firm prove to be nonviable it will be moved to judicial liquidation (liquidation judiciare. The stay is imposed on creditors and the court appoints an administrator to supervise the debtor who continues to manage the firm. The administrator (working with the "supervisory judge"), crafts the plan, which must satisfy the three purposes mentioned earlier. Employees' salaries are given highest priority and if the firm is sold as a going concern, the buyer must assume all employment contracts, leases, and suppliers. The 1985 law tried to take 'good' attribute of US's Chapter 11 and leave 'bad' attributes. The 1994 revision returned some power to the creditor without weakening the role of the court (Kaiser, 1996).

SWEDISH AUCTION BANKRUPTCY CODE

Under the Swedish bankruptcy code all bankruptcy filings are resolved through an English-style public auction requiring cash payment and the finn is liquidated piecemeal or survives as a going concern. An independent, court-appointed trustee immediately replaces the incumbent management. The code pennits DIP financing with super-priority. No deviations from absolute priority are allowed, and there is a government wage guarantee to employees up to a certain limit (Thorburn, 2000).

THE EFFECTIVENESS AND EFFICIENCY OF CODES

The discussion and the table in the preceding section show that there are remarkable differences in insolvency codes of different countries, and opinions differ as to what constitutes the "best" bankruptcy law. Furthennore, the codes have undergone revisions several times. Armed with the strengths and weaknesses we have identified from these codes, we can come up with important features, which should be borne in mind when designing a useful legal framework for ameliorating financial distress of companIes.

At least two issues are important: The first is that the law should be clear, well structured, and pragmatic so that its application achieves its objectives. In other words the law should be effective. Secondly, the legal bankruptcy process, whether it is reorganization, or liquidation, quick so that the costs of abiding with the law is minimised. This is referred to as efficiency.

Effectiveness

The effectiveness of a code is its ability to provide for how to detennine whether (in the event of financial distress), reorganization should be attempted or the case should go directly to liquidation. Information asymmetries between parties involved pose problems at this stage (Franks et ai, 1996). Different parties usually have different (sometimes conflicting) information. In addition to appropriate corporate disclosure, the bankruptcy code needs to be designed to encourage participation and sharing of information, and to discourage holding of information, and "free riding."

Efficiency

A bankruptcy law is efficient ifit achieves its goals at a relatively lower. One of the determinants of efficiency is the length of time taken from the start of the process to the end. It is reasonable to assume that both direct and indirect costs will increase with the time taken to resolve the financial distress of a company. The factors affecting this length of time include: The person to whom control and decision making is assigned during the process, the legal role of creditors in management and reorganization plan, and the possibility of DIP financing plus the accompanying super priority financing.

Other factors are specific time limits provided by a code, existence of automatic stay, and possibility of new contingent claims. The potential costs of the process will also influence the possibility of workouts, i.e. if costs are very high firms will try to restructure out of court.

Ex-ante and Ex-post efficiency

Franks et ai, (1996) document three stages of efficiency in the bankruptcy process. Ex ante efficiency (before the occurrence of financial distress), interim efficiency (when it becomes a public knowledge that a firm is in financial distress), and ex post efficiency (when there is costless sharing of information and efficient decisions are taken on the basis of complete information). Of crucial importance here is whether ex post efficiency guarantees ex ante efficiency so that optimal investment and financing decisions would be achieved both after and before the firm is in financial distress.

This reasoning follows from the argument that "...any financial contracting which is made in

order to achieve ex post efficiency will be anticipated at the inception of the debt contract" (Franks *et. al*, 1996). In other words if for example creditors expect to be affected negatively in the event of reorganization (e.g. deviation of APR), they are likely to demand a higher interest rate at the inception of the contract. In this way ex ante efficiency is affected by ex post efficiency and these effects results in sub optimal investment decisions.

Designing of an Efficient Insolvency Code

In principle the designing of an efficient bankruptcy/insolvency code should not be a complicated issue. It should be structured such that "efficient firms (i.e. asset values are highest in their current use, and going concern value exceeds liquidation value) would be reorganized and continue to survive, while only inefficient finns would be liquidated (Senbet and Seward, 1995, Franks et ai, 1996). Following Franks et ai, (1996) the following three criteria can be set to evaluate a bankruptcy code:

1). Does it preserve promising firms while liquidating uneconomic ones? A code should create correct incentives for optimal investment. Finns, which are worth more as going concerns than their liquidation value, should be preserved. Those, which are not, should be liquidated.
2. Does it allow reorganization/liquidation at a minimum possible cost? This relates to how will the code influence the size of the costs of the insolvency process both direct costs like legal, accounting, and other administrative costs (deadweight costs), and indirect costs such as lost investment opportunities, and over or under investment induced by the insolvency process. Other costs may include DIP financing and costs borne by stakeholders like employees, suppliers, customers and the government. As these other costs normally do not form part of the claims against the distressed firm, parties who bear them may be ignored in the decision to liquidate or to reorganize the firm.
3. Does it permit innovations in debt contracts to improve the process? The assessment as to whether commercial law and practice allow arrangements to evolves so as to reduce the costs of insolvency? This is not a feature of an insolvency code *per se*, it reflects the fact that the nature of a formal (court) reorganization process affects the out-of-court resolution of financial distress. This is because lessons from the US, and German have shown that private arrangements or 'workouts' have evolved to avoid some of the costs of formal reorganizations (Chatterjee *et al*, (1996), and Franks, (1996)).

Below we discuss the *pros* and *cons* of some of the codes discussed in this paper against the three criteria, we also add a fourth criterion, information production and contracting.

Preservation of Viable Firms and Liquidating Uneconomic Ones

By giving power to the debtor-in-possession (DIP) who represents the most junior claims, and the possibility of debtor-in-possession (DIP) financing with supra priority, the US code provides stronger incentives to maintain a firm as a going concern even when it is worth more in liquidation (Senbet and Seward, 1995; Franks *et al*, 1996; Kaiser, 1996). The UK code favours creditors, sometimes one creditor, as in receiverships. This is likely to result in inefficient and premature liquidation even of viable firms. As in UK, the German code gives more rights to secured creditors hence a possibility of premature liquidation. However, the new 1994 code, which came into effect in 1999, mitigates these effects by introducing automatic stay and diluting secured creditors rights through majority voting procedures.

By trying hard to maintain firms as going concern in order to preserve employment, French law fails to return viable firms to sufficient health.

Judicial arrangements resulted in liquidation in over 94% on average (Kaiser, 1996). Furthermore, the three aims of the law mentioned earlier conflict one another. The Swedish auction bankruptcy system has 75% survival rates (similar to US's Chapter 11), however, its relatively speedy, low cost process makes it more efficient mechanism for restructuring small firms (See Thorburn, (2000), and Easterbrook (1990)). Tanzania's code is essentially British but lacks the recent modifications, which UK made. There has been an international trend towards Chapter 11 style reorganization. Following this trend even UK changes in its code has tried to tap the good attributes of Chapter 11 reorganization (Thorburn, 2000).

Allowing the Firms to be Reorganized/ Liquidated at Minimum Cost

Both UK and US are likely to have lower legal and administrative costs, they also have workouts alternative, which reduce costs. The lack of a third party assessment creates a bias in favour of reorganization and delays in proceedings under US code may increase costs. German companies are kept for a long time in liquidation suggesting high costs, absence of automatic stay means that secured creditors grab their assets and lead to premature liquidation. This translates to lower legal and administrative costs but at the expense of under investment. The new code of 1999 is designed to remedy this but it will be at the likely expense of higher administrative costs.

In France, the remarkable powers given to the court to oversee and to impose the "best plan" implies that many dead-weight costs arising from inefficient bargaining, conflicts of interest and asymmetries are avoided. In this regard French code is also seen as a more "fair" code than for example Chapter 11 of the US or UK receivership. Thorburn (2000) reports that the Swedish auction bankruptcy is a speedy, low cost procedure than Chapter 11.

Permitting Innovations in Debt Contracts to Improve the Insolvency Process.

In the UK code, administration and CVAs allow for exchanges for new securities and contingency claims. In the US, because of both direct and indirect costs of the bankruptcy process, there are strong incentives for the insolvent company to come to an out of court agreement with creditors. In German, the high rate of liquidation provides strong incentives to remain outside the formal bankruptcy process. Franks (1996) cites a study, which reported that 50% of potential insolvency cases are averted through pre-insolvency restructuring. It is conceivable that firms that enter the formal process in Germany are simply the "rotten oranges" which are worth more liquidated than restructured.

Information Production and Contracting

The more perfect the information available to the markets, the more likely it will be that efficient solutions will be achieved. UK receivership does not provide incentives to generate information since control is vested in one creditor and he may use information disclosed by other creditors to his advantage. Lack of automatic stay and supra-priority does not allow time for information gathering and bargaining. On the other hand UK administration and the new German code provide the right incentives for information gathering and exchange by vesting the rights in all creditors and imposing short automatic stay. The German code allows both the debtor and the creditors to put competing plans. Chapter 11 in the US gives too much power to the debtor-in-possession (DIP), who remains in control and is also given exclusive right to submit a plan.

In the French code, the negotiated settlement enables negotiation of parties to share information with the minimum court involvement through appointing a conciliator. Under judicial arrangement, the 8 to 18 months period of observation also enables parties to assess the situation calmly.

TANZANIA'S BANKRUPTCY LAW VS OTHER CODES

Tanzanian law is essentially British law. The differences between the two is that Tanzania is still using most of the 'old' laws which were introduced by the British seventy years ago, while UK has so far changed most of her laws to suit her changing environment and level of development. However, the spirit of 'common law', which also applies in Tanzania, still prevails. This implies that most of the weaknesses and strengths in the UK laws will also be found in Tanzania laws. For example, Tanzanian code does not provide for a formal reorganization, this was a feature of British law many years ago. The weaknesses are likely to be more pronounced and damaging for Tanzania because the country has not made notable changes in its laws in equal pace with economic changes. Because Tanzania has been clinging to the original colonial code, it means the chances of firms surviving following bankruptcy proceedings are even slimmer if at all there is any.

Another weakness is in the 'wholesale' application of some UK laws and rules. For example, in section two of this paper, it was found that, in Tanzania, a UK legislation, which in the UK has already been changed, governs the appointment of a Receiver. Another example is in section 348 (1) of Companies Ordinance, which makes the Companies (Winding Up) Rules, 1929 of UK applicable to Tanzania "as construed by the courts to apply to local circumstances and to the extent not inconsistent with the Companies Ordinance." While the application of these rules and other applications of British law might have been useful as a matter of expedience during the time that decision was made, it is absurd for that provision to be there up to now for a number reasons.

First, it is clear that we did not look around whether there were better alternatives. Secondly, UK, the source of those rules, has amended its Act more than three times since then and those rules have been altered (See Companies Acts, 1985 and 989 in the UK).

There is yet another strong argument against the application of laws or rules enacted in another jurisdiction. While we are not against the common law, and not in favour of a dirigiste law, which prescribe every detail, the application gives a wide discretion as to what applies to local circumstances, and what is inconsistent with the Companies Ordinance. While we expect judges to be reasonable, it is doubtful if they are that representative to be able to judge local circumstances for the whole country and for all sectors. After 40 years of independence, such laws and rules should be passed through the legislature in accordance with section 64 of the constitution of the United Republic of Tanzania, and members of parliament debate and pass or reject them.

It should be remembered that the "forceful" introduction of the colonial laws was because at that time Tanzanian, or Tanganyika and Zanzibar were "captives" of colonial masters and had no choice. Despite the fact that legal practice in Tanzania is modelled on the British common law, since independence Tanzanian economic environment has changed and investment culture is now diverse. Globalisation, Trade liberalisation and the ongoing privatisation have brought a diversity of investment culture. There is a need for Tanzania to shop around and design a more appropriate insolvency code.

Tanzania needs to do two things: First to change its laws to match its privatisation goals, and second to learn from the shortcomings which befall UK laws and avoid them in favour of the laws of other codes discussed above, while taking the current environment into account. For example Tanzanian receivership does not provide incentives to generate information for resolving financial distress since control is vested in one creditor and he may use information from the debtor and that disclosed by other creditors to his advantage. Lack of automatic stay, and DIP

financing with supra-priority does not allow time for information gathering and bargaining during the bankruptcy process.

CONCLUSION

The paper has examined Tanzania's bankruptcy law and procedures and tested its efficiency against the benchmarks developed from the review of other eight bankruptcy codes around the globe. It has been found that bankruptcy codes in different countries differ markedly, and opinions differ as to what should be the best bankruptcy code. After assessing the strengths and weaknesses of these cords, guidelines were for developing an effective and efficient bankruptcy law have been presented and discussed.

It has been observed that during government ownership, through subsidies, public corporations kept going even if they were technically bankrupt. The insolvency code played a very limited role hence its weaknesses could not be seen. Following privatisation, investors and stakeholders need an efficient and effective code. It has therefore been suggested that Tanzania should rewrite the colonial bankruptcy law in order to shed out weaknesses taken from the old English law, some features of which are no longer found even in the UK now. Tanzania needs to be aware that even the current UK legislation has some weaknesses, which for historical reasons are also found in the Tanzanian law. These should also be avoided. Two alternatives can be taken by those in position to initiate and carry out legal reform: One is to strengthen existing provisions. The other is to re-enact a 'separate' Insolvency Act, which will consolidate the current provisions of the bankruptcy of individuals and partnerships, receiverships, winding ups, liquidation of companies, and also provide for modalities for reorganization. Short of that companies will be forced to resort to workouts i.e. "privatisation of bankruptcy."

On whether to adopt either a debtor-oriented or a creditor-oriented code we suggest the adaptation of a code, which is mid-way between the two. It may also be beneficial to adopt some features of the Swedish auction bankruptcy system, which mitigate the weaknesses of both the debtor-oriented, and the creditor oriented codes. In short, the new Tanzanian Insolvency code should try as much as possible to take the "good" attributes of the codes discussed here and avoid the "bad" attributes. The question of what is bad and what is good depends on the prevailing environment.

BIBLIOGRAPHY

Benedict, T.A (1984)
"Accounting for Bankruptcies, Receiverships and Compulsory Liquidation of Companies." NBAA, Dar es salaam.

Booth, L., V. Aivazian, Demirguc-Kunt, A., and V. Maksimovc (2001)
"Capital Structures in Developing Countries." *Journal of Finance*, (February).

Brealcy, R. A. and S.C. Myers, (2000)
Principles of Corporate Finance, 4th Edition, McGraw Hill Inc. Chapter 18.

Briston, R. J. and R.S.O. Wallace (1990)
"Accounting Education and Corporate Regulation in Tanzania", *Research in Third World Accounting*, vol. 1, 281-299, London: JAI Press.

Chatterjee, S., U.S Dhillon, and G. G. Ramirez, (1996)
"Resolution of Financial Distress: Debt Restructurings via Chapter 11, Pre-packaged Bankruptcies and Workouts." *Financial Management*, 25, (1) Spring, 5-18.

Easterbrook, F. (1990)
"Is Corporate Bankruptcy Efficient?" *Journal of Financial Economics*, Vol. 27, 411-418.

Franks, J., Nyborg, K., and Torous, W., (1989)
"An Empirical Investigation of US Firms in Reorganization." *Journal of Finance*, (July), 747-769.

Franks, J., Nyborg, K., and Torous, W., (1996)
"A Comparison of US, UK and German Insolvency Codes." *Financial Management*, 25, (3), autumn, 86-101.

Jairo, I. J., (1994)
"Financial Reporting Regulations in Post-Socialist Tanzania", unpublished M.Sc Dissertation, Stirling University, Scotland.

Jairo, I. J. (2000)
"Agency Theory: Its relevance to Tanzania's economic i restructuring", The African Journal of Finance and Management, 9, (1), July 78-88. ;Ii

Kaiser, K. M. J. (1996)
"European Bankruptcy Laws: Implications for Companies Facing Distress." *Financial Management*, autumn, 67-85.

Olsen, J.P., (1996)
"A Restructuring of Distressed Bank Debt: Some Empirical Evidence From the UK," Unpublished manuscript, London Business School.

Thorburn, K. S., (2000)
"Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival." *Journal of Financial Economics*, 58, 337-368.

Rajak, H. (1994)
"The Challenges of Commercial Reorganizations in Insolvency: Empirical Evidence from England," in J.S. Ziegel, (ed.) *Current Developments in International and Comparative Corporate Insolvency Law*, Oxford, Clarendon Press.

Rajak, H. (1994)
"The Challenges of Commercial Reorganizations in Insolvency: Empirical Evidence from England," in J.S. Ziegel, (ed.) *Current Developments in International and Comparative Corporate Insolvency Law*, Oxford, Clarendon Press.

Rajan, R. G. and L. Zingales, (1995)
"What do we Know About Capital Structure? Some Evidence from International Data", Journal of Finance, 50, 1421-1460.

Senbet, L. W. and Seward J. K. (1995)
"Financial Distress, Bankruptcy and Reorganization", in Jarrow *et al*, (Eds) , *Handbook in OR and MS*, vol. 9

URT, (1932)
"Companies Ordinance (Cap 212)"

URT, (1969) (1992)
"Public Corporations Acts"

TABLE 1: DIFFERENCES OF BANKRUPTCY CODES AMONG NINE COUNTRIES

Country	Forms of liquidation	Forms of reorganization	Control Rights	Automatic stay	Rights of Secured creditors
United Kingdom	Members' voluntary winding up, Creditors' voluntary winding up, Compulsory winding up	Administration, Administrative receivership, Voluntary arrangement	Debtors removed from control except in members' voluntary winding up.	On all creditors in administration, on unsecured creditors only in liquidation, and none in voluntary arrangements	May prevent administration by appointing own receiver. Can appoint administrative receiver to realize his security
United States	Ch.7: Voluntary (management files) or involuntary (creditors file)	Ch.11: Voluntary or Involuntary	Trustee appointed in Ch. 7, Management stays in control in Ch.11	Exist on any attempt to collect debt after filing	Get highest priority in any settlement. Their attempts to collect debt are also stayed
Germany	Liquidation: Can be requested by creditors or debtor. Management required to file as soon as it detects insolvency.	Composition: can be filed for only by debtor.	Receiver appointed to mange firm	Only unsecured creditors are stayed.	Secured creditors are not stayed and can recover their claims even after a bankruptcy filing
France	Liquidation	Negotiated settlement (*Reglement Amiable*) where the court appointed consiliator attempts a settlement with creditors and Judicial Arrangement (*Redressment Judiciaire*)	Debtor losses control in liquidation. Debtor remains in control otherwise but submits to administrator's decisions in judicial arrangement.	Stay on all creditors in judicial arrangement.	Secured creditors may lose status if court determines the security is necessary for continuation of the business, or if the security is sold as part of settlement.
Italy	Bankruptcy (Fallimento)	Preventive Composition (Conordato Preventino).	Debtor is removed from control over the firm	Stay on all creditors.	Composition allowed if enough value exists to pay secured creditors in full and 40% of unsecured creditors.
Sweden	Public Auction. Can be requested by the firm or an individual creditor.	Composition (accord) court supervised. Almost never used	Debtor is removed from control of the firm. Independent court-appointed trustee takes control the auction.	Stay on all creditors, except in limited circumstances when collateral is in creditor's physical possession.	Get highest priority in settlement. No deviations allowed. However there is no seizure.
Canada	Liquidation proceedings much like Ch. 7 in the US	Firms can file for automatic stay under the Companies Creditors Arrangement Act or the Bankruptcy and Insolvency Act.	Firm in control (reorganizations). Trustee appointed in liquidations.	Stay on all creditors in reorganization	Secured creditors have to give 10 days notice to debtor of intent to repossess collateral. Repossession stayed after.
Japan	Court supervised Liquidation (Hasan), and less costly Special Liquidation (Tokubetsu Seisan) under which a broader set of forms are eligible to file.	Composition (Wagi-ho), Corporate Arrangement (Kaisha Seiri) and Reorganization (Kaisha Kosei-ho). The list is in order of increasing eligibility. Only debtors file.	Third party is appointed except in composition and corporate arrangement.	Exists. In supervised liquidation and composition only unsecured creditors are stayed.	Have highest priority and greater voting rights in renegotiation. However can be stayed depending on the petition filed.
Tanzania	Court supervised liquidation and voluntary winding up	Receivership	Debtors removed from control except in members' voluntary winding up.	Only on unsecured creditors	Can appoint a Receiver to realize his security.

Source: Constructed from Thorburn (2000), Franks *et al*, (1996), Kaiser, (1996) and Rajan and Zingales, (1995)