

ON FORMATION OF A SHARE COMPANY IN ETHIOPIA

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Introduction

A share company does not spring into being spontaneously. It rather results from planning and other preliminary arrangements by founders. These promotional activities of founders may be classified into three categories. The first is discovery, which consists of finding the business idea to be exploited. Investigation, the second category, involves research or analysis to determine whether or not the proposed business idea is economically feasible. The third category is assembly, which includes the dual process of bringing together the necessary personnel, property and money to set the business in motion and involves the secondary details of completing the formalities requisite to set up the company.¹

Fraudulent or careless practice in this formation process can undermine permanently the financial solidity, creditworthiness and profitability of the company. Such practice can also jeopardize the legitimate interests of future creditors of the company.² Many legal systems, therefore, deem it necessary to provide safeguards to ensure that errors and malpractices fatal to the company and future creditors do not take place. Ethiopian law too has rules and institutions aimed at preventing malpractices and errors in the formation of a share company. This article aims at critically examining these rules and institutions with a view to throwing some light on those that lack clarity, identifying the *lacunae*, where any, and making suggestions to plug the legal loopholes.³

To this end, the writer discusses the fundamental attributes of a share company that underlie formation in the section that follows. In the third section, he deals with the seven specific requirements for formation of a share company. Then follows section four where he dwells on contracts concluded on behalf of a company in formation. Defective formation and its consequences are analyzed in section five. In the very last section, the author summarizes his major findings and makes some recommendations.

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¹ H.G.Henn and J.R. Alexander, Law of Corporations, (West Publishing Co., Hornbook Series, 1983) 237.

² D.F. Vagts 'Law and Accounting in Business Associations' in A. Conard(ed), International Encyclopedia of Comparative Law, (Paul Siebeck, 1972)7.

³ To gain perspective, the writer has made use of literature in various foreign jurisdictions. As regards terminology, words and terms used in Ethiopian law have been used instead of those in the references, where it is believed that will not distort the ideas in the material being used. Corporation, promoters and incorporators are terms that have been retained and recur particularly often in the article. Comparable terms used under Ethiopian law are Share Company for corporation and founders for both promoters and incorporators.

1. Nature of a Share Company

Understanding the nature or fundamental attributes of a share company helps shed some light on the formation process and the reasons behind the rules on formation. For this reason, one cannot help asking what a share company really is and its essential characteristics that underlie the formation process.

No simple answer can be found for these questions. The answer may actually vary depending on perspective and emphasis given to various theories. There are a number of theories with differing levels of emphasis on specific features of the company. For instance, the license theory tends to treat the share company as a passive device wholly at the mercy of the state for its characteristics. In this view, the share company is understood as an entity of limited powers whose characteristics, powers and those of the individuals with interest in it are wholly defined and limited by the state.⁴ The concession theory according to which the corporation is created by a grant, from the state, of privileges to form an artificial entity seems to be very close to this understanding of the corporation. Hence, the corporation may be characterized as a legal construct having an existence separate from that of the participants in the enterprise.⁵

Some, however, are of the view that the foregoing understandings tend to oversimplify the reality of the corporate enterprise. According to Larry C. Backer, for example, it is individuals that, in the very real sense, enjoy benefits, take the risks and assume responsibilities we lump together under the legal concept of corporation. The principal participants in the corporate enterprise are owners, managers, and employees while creditors, suppliers, customers, franchisees etc...play a secondary role.⁶ So, the corporation might be understood as a series of bargains between these actors with conflicting interests and legally specified powers and duties.⁷ It seems, this view meshes in well with the “free” or “normative” outlook according to which a corporation is formed by the voluntary act of founders conforming to the general norms established by the legislature.⁸

The foregoing nuanced understandings make it clear that the exact nature of a share company remains elusive. One should, however, note that the concept of Share Company is a conclusory label, not an analytical tool. If consequences are said to flow from it, they are statements of policy, not logical necessities.⁹ So, one should not overemphasize the role of logic in the matter. The share company in Ethiopia is no exception to this. With this in mind we will look at some of the features of a share company that the Ethiopian Commercial Code of 1960, (hereinafter the Code), indicates help us understand its nature, and hence the ideas that lie beneath the formation process.

⁴ L.C.Backer, Comparative Corporate Law: United States, European Union, China and Japan (Durham: Carolina Academic Press, 2002) 323.

⁵ R.M. Buxbaum, ‘The Formation of Marketable Share Companies’ A. Conard(ed), International Encyclopedia of Comparative Law,(Paul Siebeck 1975) 4.

⁶ L.C.Backer, Comparative Corporate Law, op cit, 304.

⁷ Id. 323.

⁸ R.M.Buxbaum, ‘The Formation of Marketable Share Companies’, Op. Cit,4

⁹ Id. 35.

According to the Code a share company is a legal person, whose liabilities are met only by its assets.¹⁰ Members are liable only to the extent of the contributions promised but not effectively made.¹¹ So, understanding the nature of a share company, and hence the formation process presupposes understanding the attributes of legal personality, the extent of liability of shareholders and the related concept of capital. For this reason, a brief discussion of the three follows.

1.1 Legal Personality

In spite of occasional refusal by courts and commentators to treat the company as really separate from its shareholders that a share company and its 'owners' are distinct and separate, each with different rights and obligations is thoroughly entrenched.¹² The same holds true in Ethiopia. The Code vests in a share company legal personality.¹³ The law regulates this 'singularity' it 'creates' The nature of that regulation may depend on the underlying understanding of that singularity. Therefore, the way in which different jurisdictions approach corporate regulation is substantially affected by the underlying understanding of the 'corporate personality.'¹⁴ The same holds true regarding regulation of the formation process.

As a legal person a company has certain powers 'necessarily and inseparably incident to every corporation' such as the power to sue and be sued, the power to acquire capital by selling its shares, the right to appoint agents, the power to compromise *bona fide* disputes etc....¹⁵ The foregoing implies that it is the subject of rights and obligations, in its own right, distinct and separate from its shareholders, directors, managers and creditors etc.... It may, therefore, enter into contracts not only with the outside world but also with its members whom it can sue and by whom it can be sued. The transactions of a share company create legal rights and obligations vested in the company itself as opposed to its members. The property owned by the share company is distinct from that of shareholders' So, shareholders cannot use, mortgage, and alienate etc... company property for private purposes. Set off is not possible between creditors of a shareholder and debtors of the share company.¹⁶

¹⁰ Commercial Code of the Empire of Ethiopia Proclamation, 1960, Arts 212 & 210, Proc No. 166, Neg. Gaz. Year 19, no. 3.

¹¹ Id Art 304 and 499(4)

¹² W.L.Church,Cases and Materials on Agency and Business Organizations Vol. II, (Unpublished Teaching Material, Haileselassie I University, 1965) 385.

¹³ Commercial Code Art 212 and 210

¹⁴ L.C.Backer, Comparative Corporate Law, Op.cit, 324.

¹⁵ J.L. Stewart and M.L.Palmer, Company Law of Canada,(Toronto: The Carswell Company Ltd,5th ed.,1962) 46.

¹⁶ W.L.Church, Cases and Materials on Agency and Business Organizations, Op cit 385. Preclusion of set off is true even for partnerships in Ethiopia (Commercial Code Art 257) while partners may use partnership property for personal ends so long as that does not prejudice the interests of the partnership and the rights of other partners to similarly use the same (Commercial Code Art 245)

In sum, the share company in Ethiopia has all the attributes of full corporate personality as is known in the west¹⁷ Most of the foregoing attributes like distinction between rights and obligations of members and the association, capacity to perform acts consistent with its nature and being party to legal suits are explicitly vested in associations under the Civil Code.¹⁸ Though the Commercial Code does not explicitly vest similar attributes in share companies it can be argued cogently that all these attributes do apply to share companies, necessary changes having been made. This is so, owing to Art 1 of the Commercial Code, which provides ‘unless otherwise provided in this Code, the provisions of the Civil Code apply to the status and activities of persons and business organizations....’ That means, in the absence of contrary stipulations in the Commercial Code, the attributes of personality of associations in the Civil Code apply to the personality of business organizations. What is more, jurisprudence has it that, most of these attributes are ‘necessarily and inseparably incident to every corporation’ as seen above.

1.2 Limited Liability

A defining feature of a share company that underlies the rules on formation is the limited liability of members save in exceptional circumstances stipulated by law. Vesting the benefit of limited liability in shareholders is necessitated by the need to shift some of the costs of innovation and its failures to the creditors and employees of companies.¹⁹ It is maintained that people would be reluctant to invest in large and very risky endeavors without the protection afforded by the concept of limited liability. As a result, it is contended, much human progress would be considerably slowed.²⁰ It is further argued that conferring the benefit of limited liability on shareholders is compatible with generally accepted views of fairness as a widespread distribution of shares results in divorce of ownership from the opportunity to effectively participate in management.²¹ Yet another benefit of this rule is that it minimizes the impairment of capital markets. The idea is that in the absence of limited liability creditors would pursue wealthier shareholders first, and the practical imposition of liability would be influenced by the relative wealth of shareholders. As a result, an investment decision would involve a judgment on the financial conditions of not only the company itself but also of fellow shareholders. This would entail substantial cost of acquiring information about the enterprise and fellow shareholders. The bottom line: raising capital would be less efficient and organized securities markets would be impaired.²² Other alleged benefits include avoiding increased agency costs, facilitation of the diversification of portfolio, and minimizing contracting costs.²³ We cannot dwell on these without making unwarranted digression from the theme of this article.

¹⁷ See: W.L.Church, *Cases and Materials on the Law of Agency and Business Organizations*, Op cit pp 385- 389.

¹⁸ Civil Code of the Empire of Ethiopia Proclamation, 1960, Arts 451 454, 455 Proc. No. 165, Neg. Gaz. Year 19, No. 2.

¹⁹ L.C.Backer, *Comparative Corporate Law*, Op cit, 995

²⁰ Ibid

²¹ Ibid

²² Id, 996.

²³ Id, 996 to 997.

In keeping with the laws in other jurisdictions, in Ethiopia, only the assets of the company meet the liabilities of a share company.²⁴ Assets are the sum total of what the company owns in a general sense.²⁵ They include what the company got from shareholders by way of contribution and earned surplus. Of the original value of contribution from members, the part that corresponds to the sum total of the *par value* of all the shares makes the capital.²⁶ Anything contributed by shareholders in excess of the *par value* of shares is known as issue *premium* and is not deemed part of capital²⁷ but is still part of the assets of the company. The other components of the assets of a share company are the various reserves created from the wealth generated by the company itself. The reserves could be the legal reserve required by law²⁸ reserves created because required by the articles of association and free reserve created by ordinary general meeting of shareholders, there being no requirement in the law or articles of association.²⁹ All the foregoing constitute the assets of the company available for execution by creditors. No shareholder is personally liable so long as s/he has made her/his promised contribution.³⁰

1.3 Capital and Its Protection

Considerable confusion surrounds the notion of capital under different legal systems. This is particularly so in judicial decisions and academic writings in the United States. There is similar confusion in the United Kingdom though to a lesser degree.³¹ In general, the concept of capital has been subject to greater refinement in Romano-Germanic legal systems than Anglo-American jurisdictions. At this juncture, one must note, however, that once the indispensable distinctions have been made, the basic notions of the two groups of legal systems come very close together.³² Delving into discussion of the concept of capital and the subtle differences in different legal systems is beyond the purpose of this article. For our current purpose, suffice it to say, shareholders acquire rights in a company by paying or agreeing to pay for the shares they take, in money or assets which the company agrees shall be treated as having certain value, and share capital, is the money or the assets contributed by members to the company's resources.³³ The money or assets, which are contributed, become the company's property, but the company does not become the shareholder's debtor for its repayment.³⁴

Because the liability of shareholders is limited to their contribution as seen above, there is a need to balance this against the interest of creditors. Hence, capital plays a critical role in a

²⁴ Commercial Code, Art 304(1).

²⁵ See generally, P.Mc. Carthy, Materials for the Study of the Law of Agency and Business Organizations,(Unpublished: Haleselassie I University, 1972) 118. For a more technical definition read Commercial Code Arts 73,10, 74,78, & 79.

²⁶ Commercial Code Arts 10, 73, and 82.

²⁷ Id, Art 326 and 455.

²⁸ Id. Art 454.

²⁹ Id. Art 453.

³⁰ Id. Art 304(2).

³¹ P.V. Ommeslaghe et al 'Capital and Securities of Marketable Share Companies', in D. Vagts(ed), International Encyclopedia of Comparative Law(Paul Siebeck 1990) 3.

³² Ibid.

³³ R.R. Pennington, Pennington's Company law,(London: Butterworths &Co.Ltd,1990) 135.

³⁴ Id 136.

share company in Ethiopia unlike in partnerships and sole proprietorships where at least some of the investors are personally liable to creditors of the firm.³⁵ In Ethiopia, the capital of a share company is always fully subscribed³⁶, if not fully paid, and is deemed to be a general security for the payment of the debts of the company. For this reason, the law on share companies is replete with provisions that are meant to ensure the company has assets equivalent, at least to its capital at any given point in time.³⁷ We, thus, have elaborate rules that are aimed at effective raising of capital on which we will dwell at a later stage. This emphasis that the law puts on raising the capital may be said to be a defining characteristic of a share company. In deed, the concern of the law with effective raising of capital explains a whole host of the provisions of the law on the formation of a share company.

2. Requirements for Formation of a Share Company

In some jurisdictions, the formation of a share company normally poses few significant legal problems with some exception to regulated sensitive industry sectors.³⁸ Particularly, in Common Law traditions like USA, and UK it is a very simple, fast and routine process unless shareholders contemplate a complex capital structure from the moment of incorporation.³⁹ In contrast, incorporation in Continental European states can be a complex process in which errors fatal to the corporation can take place.⁴⁰ With respect to the incorporation process, Ethiopian law resembles very much Continental European countries like France and Germany. Ethiopian law requires fulfillment of seven particulars. These are:

1. Minimum of five members
2. Minimum initial capital
3. Full subscription of the capital
4. Payment of ¼ of the *par value* of cash shares
5. Submission and valuation of contributions in kind
6. Adoption of memorandum and articles of association and
7. Registration and publicity requirements

We will dwell on each of the above, in this particular order, in the pages that follow.

2.1 Minimum of Five Members

Less than five members cannot establish a share company.⁴¹ One may contend that none of these five should be a straw person. In other words, it could be maintained the spirit of the law is that contributions by each should be of the extent required for carrying out the

³⁵ Regarding the differences among business organizations on the point of members' liability to creditors compare Commercial Code Arts 304 with Art 255,276(1), 280, & 296.

³⁶ Commercial Code Art 312(1)a.

³⁷ G.Everett, The Commercial Code of Ethiopia Selected topics,(Unpublished: Addis Ababa University Faculty Of Law, 1972) 23.

³⁸ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law, Op cit, 1.

³⁹ L.C. Backer, Comparative Corporate Law, Op cit 665.

⁴⁰ Id 667.

⁴¹ Commercial Code Art 307(1)

purpose of the company. This, one may contend, can be inferred from Art 229(3) of the Commercial Code, which provides contributions to a partnership must be of the nature and extent required for carrying out its purpose. If the law requires sufficiency of contribution in a partnership where partners are personally liable, and hence capital is not of critical importance, for a stronger reason, the amount of contribution of a shareholder in a company should not be nominal. This argument could perhaps be further buttressed by the fact that the law requires a company to have a minimum of three directors and that the directors are supposed to deposit directors qualification shares with the company, which are to be a security for the proper discharge of their obligations.⁴² So, arguably contributions by straw men are not acceptable even though the Ethiopian law on Share Company is silent on that. Hence, it might be maintained that the law requires five members who each make contribution, which helps in the attainment of the purpose of the share company, not straw men.

The foregoing view could be challenged though. It may be maintained that the minimum permissible *par value* of a share is ten Birr and the law does not specify a minimum number of shares a person should have⁴³ So, it could be contended that a person could invest as little as ten Birr. In other words, it may be held that the amount of the contribution by each member should not be subject to any inquiry as taken alone no shareholder's contribution is enough and even taken together a share company can always be under-capitalized seen from the view point of its business. An additional argument based on policy could be made in support of this view. It could be held that inquiring into the extent of contributions by each member would unnecessarily impede the raising of capital. In other words, people with small savings to invest would be barred from investing because of this requirement. This would ultimately deny the company the opportunity of raising funds from a large pool of investors. In view of all these, it may be argued, the contention that contribution by straw men is illegal does not hold water. It may, therefore, be maintained that it is very easy to comply with the law on this point. All that is needed is finding straw men who contribute ten Birr each. As far as my research could uncover, no Ethiopian court or administrative agency inquires into the extent of the contribution by members. Thus, complying with the requirement for the minimum number of members to form a share company is very easy.

A possible justification for the insistence on the company having the prescribed minimum number of shareholders at formation and for that matter at all times⁴⁴ is that the Ethiopian law envisages management organs for the share company where only members of the company can be directors.⁴⁵ Under sub 2 of Article 347 every share company should have a minimum of three directors. It also needs to have a meeting of shareholders which is the ultimate authority which appoints, monitors, dismisses etc...the directors.⁴⁶ So, it may be argued that the company will not be able to have the organs of management that the law anticipates unless it has at least five members.

⁴² Id. Art 347(1)(2) and 349

⁴³ Id. Art 306(2)

⁴⁴ Id. Art 311(1)

⁴⁵ Id. Art 347(1)

⁴⁶ Id. Art 419

2.2 Minimum Initial Capital

One of the most significant events in the accounting life of any company is its financial creation through the contribution of cash and assets tangible or otherwise by its shareholders. Many legal systems deem it necessary to provide safeguards to ensure that fraudulent or careless practice in formation do not undermine permanently the financial solidity, creditworthiness and profitability of the new company. One of such safeguards is that which requires the capital contributions of the founders equals a specified minimum.⁴⁷ This minimum capital requirement has two major objectives. The first is preserving creditors from becoming involved with companies that are financially too frail. The second is to prevent investors from choosing a corporate form when it is too cumbersome and expensive for their intended operations.⁴⁸ In other words, where the capital needed is very small, investors are encouraged to form other types of business organizations that are easier to form, and not a share company. Professor Escarra, one of the drafters of the Code, emphasizes this latter role.⁴⁹ In sum, the idea behind this requirement is to prevent the failure of companies owing to under-capitalization and, thus, safeguard the interest of stakeholders like shareholders and most importantly creditors of the company as shareholders are not personally liable to company creditors. Owing to its perceived and real role in protecting creditors, the minimum legal capital is sometimes referred to as the 'ransom' for limited liability.⁵⁰

The statutory requirements regarding minimum initial capital for share companies follow no particular pattern. In some countries high requirement is the rule. In some others, an amount, which was once deemed very high, has become meaningless through inflation and devaluation, as the law is not amended to keep pace with the diminishing buying power of money.⁵¹ Yet in others, you have a small amount. Some other jurisdictions do not even require minimum initial capital for the formation of a company. As is well known, the Common Law tradition is opposed to the idea of a minimum capital requirement. Even the few American state codes that specify minimum capital make it a prerequisite for commencing operations as opposed to formation.⁵² The practice in the US with regard to minimum capital is typified by the traditional approach illustrated by the Delaware Corporate Law and the modern approach exemplified by the Revised Model Business Corporation Act. Neither approach stipulates a certain minimum aggregate amount of capital to be contributed to the corporation. Each corporation is free to determine its own minimum. Yet, all corporations are required to be adequately capitalized. So, the question

⁴⁷ D.F.Vagts, 'Law and Accounting in Business Associations' in A.Conard(ed), International Encyclopedia of Comparative Law, Op cit 7.

⁴⁸ Id 8.

⁴⁹ P.Whinship (ed), Background Documents of the Ethiopian Commercial Code of 1960 (Addis Ababa: Artistic Printing Press, 1974) 61 .

⁵⁰ Kgeens and B.Servaes 'Corporations and Partnerships in Belgium' International Encyclopedia of Laws(The Hague: Kluwer Law International,1997) 69.

⁵¹ R.Buxbaum 'The Formation of Marketable Share Companies', in A Conard(ed), International Encyclopedia of Comparative Law, Op cit pp 9-10.

⁵² *Ibid*.

of adequate capitalization is determined on a case-by-case basis by the corporation itself.⁵³ Where the corporation is found to be too thinly capitalized, serious consequences follow under corporate, bankruptcy and tax laws. For instance, shareholders may face personal liability for corporate debt in certain cases. Similarly, the priority of shareholder rights to repayment from out of a bankruptcy estate can be reduced by the doctrine of equitable subordination in bankruptcy. What is more, tax authorities may recharacterize shareholder debt as equity under principles of US federal tax laws.⁵⁴

With respect to the legal minimum capital, Ethiopian law resembles continental European jurisdictions that stipulate a legal minimum. Art 306 of the Code provides “the capital of a share company shall not be less than 50,000 Ethiopian Birr.” So, shareholders are required to make available to the company at least this much resources at formation. This sum is, therefore, the ‘ransom’ for the benefit of limited liability in Ethiopia. This may have been a huge sum by Ethiopian standards, in 1960, when the Code was issued. Today, due to inflation, devaluation and other factors, this is a very negligible amount. So, many share companies that satisfy this legal minimum capital will be undercapitalized from the economic vantage point. Yet, the law attaches no legal consequence to economic undercapitalization unlike in the US where failure to adequately capitalize the company will have various repercussions on shareholders.

2.3 Full Subscription of the Capital

In legal systems that recognize share companies or similar organizations by different appellations, the company capital is regarded as an essential prerequisite for the company’s existence without which it cannot be set up.⁵⁵ In Ethiopia too a share company cannot be formed without capital. In fact, the law clearly stipulates that a share company is a company whose capital is fixed in advance and divided into shares.⁵⁶ The founders will, through the feasibility studies they conduct or cause to be conducted, determine the amount of resources the shareholders will have to make available to the entity.⁵⁷ So, the capital is predetermined. Many jurisdictions go beyond requiring fixing the capital of a share company in advance. They require subscription of the capital. In fact, Continental European countries, apart from the Netherlands, always required subscription in full of the corporate capital.⁵⁸ In keeping with this tradition, the Code provides, a share company shall not be formed until the capital has been fully subscribed.⁵⁹ Subscription in the pre-incorporation context means offers by interested investors to purchase shares when the share company is subsequently formed.⁶⁰

⁵³ L.C.Backer, Comparative Corporate Law, Op cit 795.

⁵⁴ Id.

⁵⁵ P.V.Ommeslaghe et al, ‘Capital and Securities of Marketable Share Companies’ in D. Vagts(ed), International Encyclopedia of Comparative Law, Op cit 3.

⁵⁶ Commercial Code Art 304(1).

⁵⁷ See: H.G. Henn and J.R. Alexander, Law of Corporations, Op cit pp 236-238.

⁵⁸ P.V.Ommeslaghe et al, ‘Capital and Securities of Marketable Share Companies’ in D. Vagts(ed), International Encyclopedia of Comparative Law, Op cit 9.

⁵⁹ Commercial Code, Art 312(1).

⁶⁰ J.E Moye, The Law of Business Organizations(St Paul: West Publishing, 4th ed,1994) 235.

In the Ethiopian context, one might argue, subscription is an ‘acceptance’ by an investor to purchase shares, rather than an ‘offer’ to do the same. To buttress this viewpoint, one might raise Art 318, which provides ‘a *prospectus* is an offer to subscribers made by the founders’ This, it might be argued, shows that the subscribers are responding to the offer already made, and hence upon subscription the contract to buy shares in the company under formation is complete. This, of course might have interesting repercussions on revocability of subscription and the ability of the company to decline subscriptions. Discussion of these subtleties is beyond the current theme. So, suffice it to say that full subscription of capital entails acceptance by investors to buy all the shares into which the capital of the company is divided and offered by founders for sale, at least in cases where the company is formed by public subscription.⁶¹

Whether a binding offer to buy shares or acceptance of offer already made to that end, the subscription of capital is necessary because every company needs capital to commence business, and investors must be identified and promises to purchase shares must be secured before the new enterprise goes operational.⁶² The fact that Ethiopian law requires full subscription, therefore, forecloses the possibility of formation of a share company without, there being sufficient interest to invest therein, hence minimizing the number of failing companies. In Continental Europe, this subscribed capital is an essential element of the company, endowed with a certain measure of permanency. The founders must therefore, establish it and its amount must be specified in the memorandum of association. It can be modified only in compliance with a variety of safeguards and formalities designed to protect both shareholders and creditors.⁶³ The law in Ethiopia follows this tradition. The memorandum of association must state the amount of the subscribed capital.⁶⁴ What is more, changing the subscribed capital requires compliance with various rules that the law puts in place to protect shareholders and creditors alike.⁶⁵

2.4 Payment of ¼ of the par value of cash shares

If capital safeguards offer any significant protection to creditors of the company, it lies in their application to the capital that is actually paid in. In other words, subscribed capital will not be of much utility to creditors as collection of subscriptions is likely to become difficult at the very moment the money is needed.⁶⁶ Aware of this problem, some laws like that of the European Union require the founders to put some real assets at risk before they commence business. Even seen from the vantage point of the company’s own practical need, it is important that a company collects and reports assets in amounts that bear a reasonable relation to the risks of its business, before it embarks on operation. Otherwise, it might not be regarded as creditworthy.⁶⁷

⁶¹ Commercial Code Arts 317 to 322.

⁶² J.E Moyer, *The Law of Business Organizations* Op Cit 235.

⁶³ P.V.Ommeslaghe et al, ‘Capital and Securities of Marketable Share Companies’ in D. Vagts(ed), *International Encyclopedia of Comparative Law*, Op cit 4.

⁶⁴ Commercial Code Art 313(5).

⁶⁵ Id. Arts 431, 484 to 494, 454,470 to 473.

⁶⁶ A.F.Conard, ‘One Hundred Years of Uniform State Laws: The European Alternative to Unifying Incorporation Laws’(1991) 89 *Michigan Law Review* 24.

⁶⁷ Id.

The Ethiopian law on this point requires shares subscribed in cash be paid up upon subscription as to one fourth of their *par value* or a greater amount if so provided in the memorandum of association.⁶⁸ This was necessitated, according to the draftsman, Professor Escara, by the need to put in place 'a sound commercial regime' that provides security to creditors.⁶⁹ To avert loss of the money, the law in Ethiopia requires, this amount be paid up and deposited in a bank, in the name and to the account of the company under formation.⁷⁰ The official in charge of the Commercial Register will require proof of that before registering the company.⁷¹ The remaining three fourth can be paid in a period not exceeding five years, according to the plan to be formulated by the company pursuant to Art 342 of the Code. Some European jurisdictions do not believe payment of one-quarter provides sufficient security. A case in point is the current French law, which provides 'shares subscribed in cash be paid in respect of at least fifty *per cent* of their face value'⁷²

2.5 Contributions in Kind: Usefulness, Validity, Submission and Valuation

In an organization like a share company where the liability of members is limited to their contributions, the contribution of members is instituted as much in the interest of creditors as in that of other members and the business firm itself.⁷³ Hence, there is a need to take particular care to ensure that a contribution by a person does not jeopardize the interest of all stakeholders and especially that of the creditors of the company. In this regard, contributions in kind pose a host of problems. Of particular concern in this respect are: a) usefulness of the contribution b) validity of service as contribution. c) lawfulness and morality of contributions and d) submission and valuation of contributions.

a) Usefulness of the contribution: One issue that raises its head in relation to contributions in kind is usefulness of the contribution in the attainment of the business purpose. Accepting contributions in kind which are manifestly useless jeopardizes the success of the company. This in turn exposes creditors to greater risk than anticipated, as the wealth generated by the company too is their security.⁷⁴ Besides, ultimately the interests of the shareholders who made useful contributions are adversely affected as the company's chances of success will be low. Owing to this, and due to the fact that accepting a useless contribution might be regarded as a breach of trust on the part of the founders, the contribution should be such that it helps in the attainment of the business purpose of the share company. In recognition of this, some jurisdictions explicitly require that the contributions in kind be of such a nature that they facilitate the attainment of the business

⁶⁸ Commercial Code Art 338(1).

⁶⁹ P. Whinship (ed), Background Documents of the Ethiopian Commercial Code of 1960, Op cit 62.

⁷⁰ Commercial Code Art 312(1)b.

⁷¹ Id. Arts 323 and 97.

⁷² Law No 2003-7 of 3 January 2003 Articles 50 (ii) and L225-3 Official Gazette of 4 January 2003.

⁷³ J. Heenen, 'Partnerships and other Personal Associations for Profit' in International Encyclopedia of Comparative Law (Paul Sieback 1978) 169.

⁷⁴ Commercial Code Art 304(1).

purpose of the company. A case in point is the Belgian law that requires incorporators to draft a report indicating the importance to the company of each contribution in kind.⁷⁵

The Ethiopian company law remains mute on the issue of usefulness of contributions in kind. This should not, however, delude one into thinking that a person can make contributions that are manifestly useless. That would run contrary to the legitimate interests of creditors and other stakeholders. Besides, one may maintain that, the fact that the law on partnerships specifies contributions must be of the 'nature' required for carrying out the purpose of the enterprise,⁷⁶ implies the same for companies. There is a stronger reason for requiring that in the context of share companies where none of the shareholders is personally liable to creditors unlike in partnerships where at least one partner is liable to creditors even beyond his/her promised contribution.⁷⁷ In spite of this, there is no mechanism in the formation process in Ethiopia to ensure the usefulness of contributions.⁷⁸ Hence, requiring the founders to file a report on the usefulness of contributions in kind, as under the Belgian law, seems in order.

b) Validity of contribution of service: Another issue one confronts in relation to formation is whether even where useful contribution of service is valid. Some jurisdictions lay this question to rest by taking position explicitly. The current French Law, for instance, provides, shares may not represent contribution in the form of service.⁷⁹ Similarly, under OHADA Treaty, now in force in more than 18 Francophone African countries, only cash and in-kind contributions are allowed. Contributions of know-how, work and services (*apports en industrie*) are prohibited.⁸⁰ One possible reason for such prohibition is that contribution of service is of limited utility, if any, to the creditors of a company that has defaulted.

Unlike in the foregoing countries, the law in Ethiopia does not expressly prohibit contribution of service. In fact, it may be cogently argued that contribution of past services, unlike future services, does not seem to jeopardize the legitimate interest of stakeholders in the matter and is permissible where rendered by persons other than founders. This is implied from the fact that the company is under obligation to take over commitments entered into by founders and reimburses all expenses incurred, among others, to pay for services rendered, so long as the services were necessary for the formation of the company.⁸¹ So, one may contend, there is no material difference in effecting payment for such services from the capital and writing off the money owed by the company by issuing shares instead to people other than founders who rendered services in the formation process. This viewpoint is particularly convincing as the law expressly allows, *albeit* in relation to increase of capital after formation, issuing shares to pay off current debts in

⁷⁵ K.Geens and B Sarves, Corporations and Partnerships in Belgium, International Encyclopedia of Laws, Op Cit 62.

⁷⁶ Commercial Code Art 229(3).

⁷⁷ Compare and Contrast Commercial Code, Arts 255(2), 276(1), 280(1), 296,300 with 304(2).

⁷⁸ Interview with Ato Ermias G/Mariam, Registration Officer, Registration and Licensing Department, Ministry of Trade and Industry, February 6, 2008

⁷⁹ Law No 2003-7 of 3 January 2003 Articles 50 (ii) and L225-3 Official Gazette of 4, January 2003.

⁸⁰ Earnest and Young International, A Guide To OHADA Treaty(Unpublished Brochure) 6.

⁸¹ Commercial Code Art 308(2).

order to increase capital.⁸² The service rendered by founders is treated differently owing to the need to protect subscribers from founders securing unreasonably high rewards taking advantage of their dominant position at this early stage, according to Professor Escara.⁸³ To this end, Commercial Code Art 310 expressly prohibits conferring on founders any benefit other than reserving a share in profits not exceeding one fifth of the profits in the balance sheet for a period not exceeding three years. In fact, Art 310(3) specifically states no founder shares may be issued.

In contrast, it may be argued, the law impliedly prohibits an undertaking to render service in the future. This can be gathered from Art 339(1), which provides shares representing contributions in kind are fully paid for, not later than the day of the registration of the company. It seems, therefore, a promise to render service to the company after formation can never be a valid contribution, and hence cannot form part of the capital of a share company. This viewpoint is further strengthened by the fact that contribution of service is of limited utility to creditors of the company, should the company default. The creditor may not have any interest in getting the service promised by the shareholder. Even if creditors were by some curious circumstances interested in that, specific/forced performance is not required where that affects the personal liberty of a debtor, as does rendering service, under Ethiopian law.⁸⁴

c). Lawfulness and Morality of Contributions: The legal act of contribution may be null and void because its object is unlawful or immoral.⁸⁵ “Unlawful” obligations are those contrary to public law or to the mandatory rules of private law. In relation to obligations to convey rights on things as contribution, the object could be unlawful if the thing being contributed is not *in commercio*, that is, non-conveyable by law. For instance, parts of the human body are not *in commercio*.⁸⁶ Hence, they cannot be contributed to a company. More importantly, goods excluded from private commerce on grounds of public health as well as things excluded from private commerce for other reasons like public domain property⁸⁷ and all land in Ethiopia cannot be contributed to a company. Regarding land, one notes that the FDRE Constitution vests ownership of land exclusively in the ‘State and in the peoples of Ethiopia’⁸⁸ Hence, ownership over land cannot be contributed. Note, however that, leasehold right on land, be it on rural or urban land, can validly be contributed.⁸⁹ Regarding immoral objects, it suffices to say that a contribution may be found to be null on this ground by courts. Venturing into what kind of contributions may be

⁸² Id. Art 464(2)b.

⁸³ P. Whinship (ed), Background Documents of the Ethiopian Commercial Code of 1960, Op cit 62.

⁸⁴ Commercial Code Art 1 read together with Civil Code Arts 1776, 2583. See Also Civil Procedure Code Decree, 1965, Arts 389(1), 400(1), 394, 399, 401 Proc No. 52., Neg. Gaz. Year 24, No. 3 and George Krzeczunowicz, Formation and Effects of Contracts in Ethiopia (Addis Ababa: Addis Ababa University, Faculty of Law 1983) pp 124-126.

⁸⁵ The Civil Code Art 1716. Note at this juncture that the Civil Code complements the Commercial Code because the latter in its first article clearly stipulates that.

⁸⁶ Civil Code of Ethiopia, 1960, Op cit. Art 18.

⁸⁷ Id Art 1454.

⁸⁸ FDRE Constitution Proclamation, 1995, Art 40(3) Proc. No 1, Neg. Gaz. Year 1, No. 1.

⁸⁹ Re-Enactment of Urban Lands Lease Holding Proclamation, 2002, Art 13(1), Proc. No. 272 Neg. Gaz. Year 8, No. 19. See also Rural Land Administration and Land Use Proclamation, 2005, Art. 8(3), Proc. No. 456, *Fed. Neg. Gaz.* Year 11 No. 44.

deemed moral or immoral here would be intruding into the courts authority probably for no useful reason.⁹⁰

d) Submission and valuation of contributions in kind: If the capital of the company is to be raised effectively, thus, foreclosing putting at risk the interest of creditors, shareholders and the company itself, contributions in kind must be submitted at the earliest possible time. What is more, their value should not be exaggerated. To this end, Ethiopian law requires contributions in kind be fully made at the very latest on the day of the registration of the company.⁹¹ To prevent overvaluation of contributions in kind, previously, the law ordained that a member who makes a contribution in kind file a report made and sworn by experts appointed by the Ministry of Trade and Industry.⁹² These disinterested experts were required to state the method of valuation they followed, and indicate the value they gave to each of the items contributed.⁹³ Furthermore, this report by independent experts was to be annexed to the memorandum of association so that third parties would have the chance to have a look and make their own judgment.⁹⁴ According to Professor Escara., this system of valuation, which was, in part, borrowed from the Italian Civil Code, was one of the most simple and effective methods available.⁹⁵ Indeed, it does seem to be very effective. Unfortunately, the foregoing system of valuation is no longer in place. The agreement of founders or members of the company as to the value of the contributions in kind has substituted this method.⁹⁶ So, all that the new law requires is founders, and where the company is formed by public subscription⁹⁷ other members too, agree on the worth of contributions made in kind.

The system currently in place is fraught with problems. For one thing, it might be impractical where there are a large number of shareholders with small investment each. Besides lacking the expertise necessary to value contributions made in kind, people who have invested insignificant sums might find involvement in this exercise waste of time, thus leaving it to few. These few could manipulate the process to favour themselves. What is worse, shareholders might deliberately overestimate the value of the contributions of each member in a bid to enhance the creditworthiness of their company by inflating its capital. In some cases, things could get much worse than that. An 'agreement' might be made to 'contribute' property that does not exist or does not belong to the 'contributing' member. This is possible because the notary before whom the memorandum of association is to be signed is required by law to ascertain the right of the transferor to transfer the property, only with respect to contributions made to transfer property for which title

⁹⁰ George Krzeczunowicz, *Formation and Effects of Contracts in Ethiopian Law*, Op cit pp 65-70.

⁹¹ Commercial Code Art 339(1).

⁹² Id. Art 315(1).

⁹³ Id. Art 315(2).

⁹⁴ Id. Art 315(3).

⁹⁵ P. Whinship, (ed.), *Background Documents of the Ethiopian Commercial Code* Op cit 62.

⁹⁶ Commercial Registration and Business Licensing Proclamation, 1997, Art 8, Proc. No 67, Neg. Gaz. Year 3, No. 25, as amended, Proclamation to Amend the Commercial Registration and Business Licensing Proclamation, 2003, Art 2(1), Proc. No 376, Id, Year 10, No. 9.

⁹⁷ Commercial Code Arts 317 to 322.

certificates are issued under the law.⁹⁸ Obviously, the law does not require title certificates for every type of property that might conceivably be contributed to a share company. Title certificates are issued under the law only for immovables and special movables, namely, cars and ships assimilated to immovables.⁹⁹

To prevent mischief in this regard, the people entrusted with authentication of memorandums of association have come up with a novel but problematic method. They require putative contributors of things whose ownership is not evidenced by title certificates to submit receipts of payment upon purchase, customs declarations etc.... Where such 'proofs' are not adduced they do not authenticate the memorandum of association.¹⁰⁰ The problem with this 'solution' is that these documents prove neither the ownership nor the very existence of the property indicated therein. The item indicated on such documents could well have been transferred to someone else for consideration or *gratis* or even destroyed. That they do not accept any contribution not supported by such documents is, therefore, more of a problem than a solution. By insisting on the production of these documents they are effectively excluding contribution of certain things with respect to which such documents can never be adduced such as, say, contribution by a cattle breeder of some of his oxen born to his cows.

The foregoing should not, however, mislead one into thinking that the current law has no mechanism at all aimed at averting overvaluation. It does require directors and auditors to verify and, where necessary, review the valuation made, within six months from the formation of the company. If the revaluation by auditors and directors shows that the contribution in kind was overvalued by one fifth or more, the person who made the contribution in kind is required to make good the difference.¹⁰¹ What is more, founders are jointly and severally liable for the damage resulting from such overvaluation.¹⁰² My contention is that this is too little too late. During six months of operations lots of mischief could be committed. A host of people may transact with the company in reliance of the inflated capital. So, the revaluation will be little more than shutting the stable door after the horse has bolted, especially in cases where the contributing member(s) and founders are not people of wealth, able to make whole the persons caused damage by the overvaluation. Hence, there is a need to prevent overvaluation rather than relying on *post facto* remedies.

⁹⁸ Authentication and Registration of Documents Proclamation, 2003, Art 4(7), Proc. No 334, Neg. Gaz. Year 9, No 54.

⁹⁹ Civil Code Art_1195 and 1186(2), Maritime Code Proclamation, 1960, Arts 7(1), 45 and 50, Proc. No 164, Neg.Gaz. Year 19, No 1.

¹⁰⁰ Interviews with Ato Desalegn Woldegebriel and W/ro Tsehai Mamo, Notaries at the Section for the Registration of Business Organizations and Investors, FDRE Ministry of Justice Documents Authentication and Registration Office, February 7, 2008.

¹⁰¹ Commercial Code Art 315(3) &(4). Where the verification under this sub-article results in the value of the contribution being lowered by less than one fifth it seems neither the contributing member nor the founders are liable for the balance. This, in my view, is recognition by the lawmaker of the fact that valuation is just an estimate and *bona fide* differences in value can always occur. In other words, the revaluation does not necessarily show the true value of the contributed property. Besides, the value of the contributed property could well have changed due to changes in the market situation. All these necessitate having a margin of tolerance. The lawmaker, it seems, believed that a margin of tolerance of one fifth is fair in the Ethiopian context.

¹⁰² Id Art 309(1)a.

To this end, there is a need to explore ways of getting around the problems that necessitated abolishing evaluation by disinterested experts, which presumably are lack of experts in sufficient numbers and the resultant delays in company formation. One possible solution is outsourcing this, instead of relying on employees of the Ministry. Another is introducing valuation as a business. The Ministry could license and supervise firms that engage in valuation as their business. If this does not succeed, one should perhaps think along the lines of the law on private limited companies. As can be gathered from the Commercial Code Art 519(1)&(2), it is members of the company that determine the value of contributions in kind in private limited companies. This, of course, is accompanied by accountability to those that might be adversely affected by overvaluation. Members of the private limited company are jointly and severally liable to third parties for the valuation fixed. And this liability remains, notwithstanding that a member was not aware of the overvaluation.¹⁰³ In other words, all members are personally liable, beyond their contribution to compensate those who have sustained loss as a result of overvaluation. Indeed, this solution is not without its own downside in the context of a share company where you can have theoretically thousands of shareholders, some with very small investment. Every investor would be expected to verify the value of every other investor's contributions. This could be impractical and unfair. Nevertheless, its *pros* and *cons* should be weighed.

2.6 Adoption of the Memorandum and Articles of Association

a) **Memorandum of Association:** Various national legal systems prescribe that a share company have a document known by various appellations in different countries like memorandum of association, charter, certificate of incorporation, *projet de status*, *Satzung*, *teikam* etc.... Most company laws specify a number of mandatory provisions to be included in this document.¹⁰⁴ It will also have optional provisions that do not go against the mandatory provisions of the law.¹⁰⁵ Owing to this, the memorandum normally reveals the unique nature of the company and helps particularize the company by showing the company's name, capital structure, purpose, location, number of members of the board, their powers etc....¹⁰⁶ In short, therefore, it '...constitutes both a legislative, *albeit* delegated, set of common norms, and a memorandum of agreement, not necessarily the exclusive one, between a number of entrepreneurial venturers, reflecting their understanding of the format, scope and aims of their venture'¹⁰⁷

As do the laws of other countries, the Commercial Code of Ethiopia, requires that the formation of a share company be by a public memorandum, known as the memorandum of

¹⁰³ Id Art 519 (3)&(4).

¹⁰⁴ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law Op cit 11.

¹⁰⁵ R.R. Pennington, Pennington's Company Law, (6th ed), Op cit 3.

¹⁰⁶ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law Op cit 11.

¹⁰⁷ Id 12. See also C. de Hoghton(ed), The Company: Law Structure and Reform in Eleven Countries (London: George Allen & Unwin LTD, 1970) pp 71-76.

association.¹⁰⁸ According to Art 313, the memorandum of association must contain names, nationality and address of the shareholders as well as the number of shares, which they have subscribed, the name of the company, its head office and branches, if any. It must also indicate the business purpose of the company, the amount of capital subscribed and paid up, the *par value*, number, form and classes of shares as well as the value of contributions in kind, their object, the price at which they are accepted, the designation of the shareholder and the number of shares allocated to him by way of exchange. What is more, the memorandum of association must indicate the manner of distributing profits, the share in profits allocated to founders, the number of directors and their powers, and the agents of the company. Besides the foregoing, the auditors, the period of time for which the company is to be established and the manner in which the company will publish its reports must be indicated in the memorandum of association.

The above are but the required elements of the memorandum of association. So, members can provide for such other matters, as they deem proper. Hence, each memorandum can vary significantly from another.

b) Articles of Association: It is important to distinguish between rules that might be called 'substantive' and 'housekeeping flexibility.'¹⁰⁹ According to Richard M. Buxbaum, the former actually shape the enterprise while the latter govern the routine and internal varieties of meeting and their procedures, and similar essentially parliamentary matters.¹¹⁰ Ideally, the latter functions and their ordering might be put into a less formal and flexible document known in different jurisdictions by various names such as the articles of association, *projet de statuts*, *Geschäftsordnung* etc....¹¹¹ In other words, the memorandum defines the company's objects, and confers powers on it; the articles determine how those objects are to be achieved and powers exercised.¹¹² Though this is the ideal scenario, the fact remains that there is no consensus among legal systems as to which items belong to which category. Therefore, almost every system permits some admixture of substantive and formal provisions in the same document, hence no clear-cut distinction between the memorandum and articles of association.¹¹³

The Commercial Code of Ethiopia requires the share company to have articles of association.¹¹⁴ Unlike with regard to the memorandum of association, it does not list down what the contents of this document should be. It does, however, give clues as to the possible contents in different parts of the Code.¹¹⁵ On reading the various provisions that indicate its possible contents one gets the impression that it is by and large meant to deal with in-house affairs, which have little impact on third party interest. Cases in point are,

¹⁰⁸ Commercial Code Art 313.

¹⁰⁹ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law Op cit 12.

¹¹⁰ Ibd.

¹¹¹ Ibd.

¹¹² R.R. Pennington, Penington's Company Law, (6th ed), Op cit 24.

¹¹³ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law Op cit 12.

¹¹⁴ Commercial Code Art 314.

¹¹⁵ W.L. Church, Cases and Materials on Agency and Business Organizations, Op cit 446.

one may contend, its contents like the fact that groups of shareholders having different legal status must have at least one representative in the board of directors¹¹⁶ remuneration of directors,¹¹⁷ who presides over the meeting of shareholders¹¹⁸ the possibility of extending the time at which the ordinary annual meeting may be called,¹¹⁹ and the question of representation in shareholder meetings.¹²⁰

Other provisions of the Commercial Code indicating the possible contents of the articles of association show that it may contain provisions, which might have repercussions on third parties. Good examples are Commercial Code 363(2) and 457. The former states that the articles of association must specify whether the directors are jointly responsible as managers of the company or whether one only of the directors is responsible. It may be contended that, read together with Commercial Code Arts 323(2)(b), which requires the articles of association be deposited in the commercial register and the binding effects of entries in the register¹²¹ such a provision will have consequence on third parties. Particularly, dealing with a director not indicated as the one with powers to deal with outsiders may result in unenforceable transaction. Certainly, the provisions of the articles of association dealing with the payment of fixed or interim interest¹²² have the potential to impact third parties. So, it may be argued that, in Ethiopia, the provisions in the articles of association are not limited in their impact to shareholders or in house matters. They might have far reaching consequences on third parties like creditors of the company.

Cognizant of the foregoing, perhaps, the Commercial Code deems the articles of association as part and parcel of the memorandum of association.¹²³ As a result, only an extraordinary general meeting of shareholders can amend it, with the same *quorum* and majority requirements as for the amendment of the memorandum of association.¹²⁴ The law also recognizes the interest of the public in knowing its contents. It, therefore, requires that it be deposited in the commercial register alongside the memorandum of association.¹²⁵

¹¹⁶ Commercial Code Art 352.

¹¹⁷ Id. Art 352(2)(4).

¹¹⁸ Id. Art 404

¹¹⁹ Id. Art 418(2).

¹²⁰ Id. Art 420(2).

¹²¹ Id. Art 120(2).

¹²² Fixed or interim interest is money paid to shareholders even where there are no profits during the period of preparatory works and construction of the enterprise and ceases to be payable as soon as normal business begins according to Commercial Code Art 457. If interim interest is paid before the company commences business operations, it means the payment entails return of contributions to shareholders. Obviously, this affects third parties as it reduces the capital/assets of the company, which are their security in an enterprise where every shareholder is the beneficiary of limited liability.

¹²³ Commercial Code Art 314(3).

¹²⁴ Id. Arts 423 and 425.

¹²⁵ Id. Art 323(2)a and b.

2.7 Registration and Publicity

Different legal systems recognize an institution widely known as ‘the commercial register’¹²⁶ Of course, its organization and functions vary from country to country. It may, for example, be kept by a judge or at least under judicial control or by administrative organization or even by vocational organization like a chamber of commerce.¹²⁷ The idea is that the register serves various private and public purposes such as proving the status of the business organization/trader, provision of information as to the types and levels of business activities, as an administrative record etc....¹²⁸ In fact, in some legal systems, registration in the commercial register may be an indispensable condition for entitlement to certain benefits like obtaining legal personality.¹²⁹

Like in other jurisdictions, we have the institution of the commercial register in Ethiopia.¹³⁰ The law requires that the final text of both the memorandum and the articles of association that are to be drawn up at the meeting of subscribers¹³¹ be deposited in this register¹³². It is only once the subscribers have signed these documents before a notary public¹³³ and the same are deposited in the commercial register that the company becomes a legal person.¹³⁴ Incidentally, this contrasts with the practice in some jurisdictions like most US states where this organizational meeting takes place after the corporation has come into formal existence when the incorporator files the articles of incorporation with the Secretary of the State or a comparable state official.¹³⁵ Unlike with the practice in the US, one notes a close similarity, in this regard, between the incorporation processes of share companies in Ethiopia and the Spanish *sociedad anonima*(SA) and the French *societe anonyme*(SA).¹³⁶

On top of registration, previously, the law had required publication of a notice in the official commercial gazette before a share company acquired legal personality.¹³⁷ However, the official commercial gazette, which had been anticipated by the Commercial Code, never came into existence. Thus, the law was amended to require publication of the notice in a newspaper published by the Federal Government with a countrywide circulation or published by Regional Government¹³⁸ This requirement of publication in newspaper has

¹²⁶ D.Tallon, ‘Civil and Commercial Law’ in K. Zweigert(ed), International Encyclopedia of Comparative Law ,(Paul Siebeck, 1983) 110.

¹²⁷ Id.

¹²⁸ Id.

¹²⁹ Id.

¹³⁰ Commercial Registration and Business Licensing Proclamation 67/97, Art 4. Commercial Code Arts 86-114.

¹³¹ Commercial Code Arts 320 and 321(2).

¹³² Id. Art 323(2) a & b, Council of Ministers Regulation 13/1997, Art 6(5).

¹³³ Proclamation to Provide for the Authentication and Registration of Documents, Proc No. 334/2003 Art. 2(2), 5(1)c .

¹³⁴ Commercial Code Arts 323 and 223 read together.

¹³⁵ L.C.Backer, Comparative Corporate Law Op cit 666 Compare also the Revised Model Business Corporation Act “RMBCA” Sec 2.01-2.06, 10.20-10.22 and the Delaware General Corporation Law ‘DGCL’ sec 101-109.

¹³⁶ On these two systems read L.C.Backer, Comparative Corporate Law, Op cit 668.

¹³⁷ Commercial Code Arts 323, 2223 & 87.

¹³⁸ Commercial Registration and Business Licensing Proc. 67/1997 Art 8(1)&(2).

now been abolished altogether because of the unwarranted delay that it caused in formation of business organizations, and the considerable expenses it sometimes entailed.¹³⁹

3. Contracts Made On Behalf Of Company In Formation

As can be gathered from the foregoing discussions, a share company comes into existence as a result of planning and other preliminary arrangements by founders which. Henn and Alexander classify into discovery, investigation and assembly, raised in the introduction part.¹⁴⁰ Throughout these phases founders may require the service of various professionals. They may also have to secure various options, licenses, patents, and lease etc... for the company to be formed. For these reasons, they will have to conclude contracts and incur expenses before the company is born.¹⁴¹ Therefore, the questions of whether and the extent to which founders are liable for such commitments arise.

In principle, the founders are fully jointly and severally liable in respect of the commitments entered into for the formation of the company.¹⁴² This does not mean that the transactions of the 'entity' under formation concluded by founders can be avoided by the entity after formation when third parties claim rights on the basis of the said transactions against it. Commercial Code Art 308 (2) imposes an obligation on the company to take them over. The same is true in other legal systems.¹⁴³ But as honoring these contracts will encumber company assets, there is a need to address the concerns of the subscribers who had no say on what contracts to conclude. That is why the law limits the company's obligation in this regard. The company is obliged to take over the commitments and expenses only in so far as they were necessary for the formation of the company or approved by the general meeting of the subscribers.¹⁴⁴ In relation to this, one notes that Ethiopian law does not seem to require express adoption of the commitments and expenses by the company for it to be bound. All that the third party who wants to proceed against the company has to show is that the commitments and expenses were necessary for the formation of the company.

In this regard, the question arises as to whether a third party who transacted with a founder retains the right to proceed against the founders even though the company has the obligation as seen above. The case where the founder specifically binds himself on the contract, whether or not the company to be formed wishes to or does adopt the contract

¹³⁹ Read together Proclamation to Amend the Commercial Registration and Business Licensing Proc 376/2003 Art 2(2) and Art 8(1) of Proc 67/1997. According to a pamphlet from the Ethiopian Press Agency the cost of publishing a notice that is a page long in the Ethiopian Herald or 'Addis Zemen' is 10,626:00 Birr VAT inclusive. As a result, publishing the excerpts from the memorandum of association as was required by law entailed prohibitively high expenses in some instances. What is worse, the time it took for the notice to appear was very long. Currently, any notice to be publicized needs to be submitted to the Ethiopian Press Agency ten days ahead of the desired date of publication.

¹⁴⁰ H.G.Henn and J.R.Alexander, Law of Corporations, Op cit 237.

¹⁴¹ Ibd.

¹⁴² Commercial Code Art 308(1).

¹⁴³ R.M.Buxbaum, 'The Formation of Marketable Share Companies' in A.Conard (ed), International Encyclopedia of Comparative Law Op cit 30.

¹⁴⁴ Commercial Code Art 308(2).

poses no problem. Problematic is the situation where the founder takes no such explicit responsibility.¹⁴⁵ Different legal systems give differing solutions on the basis of different theories. In Common Law systems the labels used such as adoption and novation matter. Where the term used in the law is 'adoption' of the agreement the previous contracting parties are fully liable in addition to the new party, i.e. the company. In contrast, 'novation' is an agreement for substitution of parties, and thus of liability.¹⁴⁶ So, the company takes on all the obligations assumed by the founders thus relieving the latter. Some systems infer the continued liability of the founder on the basis of agency law which provides 'unless otherwise agreed a person who, in dealing with another, purports to act as agent for a principal whom both parties know to be nonexistent or wholly incompetent, becomes a party to such contract.'¹⁴⁷ In the Civil Law systems too there are differing constructs, which might lead to different results as to the continued liability of the founders. The general tendency, however, seems to be to make them still liable, the debate being more about the obligation of the company to reimburse the founders who have paid the third party.¹⁴⁸

Given the importance of the language used in the law with regard to this issue, it is important to note that Art 308(2) of the Commercial Code says '...the company shall take over these commitments from the founders....' Is this language suggestive of novation hence resulting in substitution of parties and, therefore, obligations or is it simply entitling the promoter to reimbursement without relieving him from continued obligation towards the third party? Strong arguments can be raised in support of the latter point. One may contend that the law talks about the obligation of the company to take over the commitments from the founders, NOT about the contracting party's obligation to relinquish the right to claim from the founders. This argument may further be strengthened by the fact that at least some of the people who transact with promoters have no way of telling what the capital of the company will be. For this reason, it can be said that they rely on the credit worthiness of the promoter. Therefore, denying them the right to proceed against the promoters would be giving them less than they bargained for unless they have expressly accepted that. If this line of interpretation is taken, the result is in consonance with that reached by many countries of the Civil Law tradition as indicated above.

A host of other issues may arise in relation to pre incorporation contracts. One such issue is where a person prematurely acts on behalf of a 'share company' because he erroneously but in good faith thinks the share company has been formed. Should such person be made personally liable like a founder just because the transaction took place before incorporation? A review of recent case law in the US shows that courts have relied on common law concepts like *de facto* corporation, *de jure* corporation, and corporation by *estoppel* that provide uncertain protection against personal liability for these kinds of pre-incorporation transactions.¹⁴⁹ The Revised Model Business Corp Act, Sec 2.04 gives even more protection as it makes liability for such pre incorporation acts conditional on the third

¹⁴⁵ R.M. Buxbaum, "Formation of Marketable Share Companies" in A. Conard(ed) International Encyclopedia of Comparative Law, Op Cit 31.

¹⁴⁶ Id 33.

¹⁴⁷ Id 31 and Restatement of Agency 2nd (1957) S. 326 as quoted in footnote 200.

¹⁴⁸ Id 60.

¹⁴⁹ L Backer, Comparative Corporate Law, Op cit 686.

party knowing that there was no corporation.¹⁵⁰ It makes sense to exempt from personal liability a person who honestly and reasonably but erroneously believed to represent a company when there was in fact no company at the time.

This does not seem to be the position taken by Ethiopian law. It provides that the ‘founders are liable for commitments entered into for the formation of the company’ It then continues ‘...*all persons* who have acted in the name of the company before its registration in the commercial register shall be *similarly liable*’¹⁵¹ Remember at this juncture that, the company’s legal personality and existence commences upon registration under Ethiopian law.¹⁵² So, such people are personally liable like founders though unlike founders they might believe in good faith that the company already exists. Ethiopian law is not alone in taking such a position though. Many US states have statutes, which provide expressly that those who prematurely act for or on behalf of a corporation are personally liable on all transactions entered into.¹⁵³

4. Defective Formation and its Consequences

Traditionally, legal systems made distinction between two categories of defects in the formation of a company. The first category pertained to the concept of ‘agreement to form a corporation’ or in American usage ‘underlying joint venture’. Defects pertaining to vices in consent like a ‘shareholder’ joining the company under duress, owing to fraud or mistake fall in this category of defect.¹⁵⁴ In other words, the initial act of incorporation of a share company is but a contract. Thus, validity requirements for the formation of a contract are applicable to the creation of a share company.¹⁵⁵ So, defects pertaining to the validity requirements of the contract comprise the first category of defects. The second category of defects comprised improper publication of the memorandum, defects of form thereof, failure to hold organizational meeting and the like, which are more formal or technical in nature. These technical defects had no retroactive annulling effect on the company while they could result in dissolution of the company.¹⁵⁶

There was less uniformity as regards the consequences of defects of the first category. In pre 1967 French law, for instance, defects in relation to ‘agreement to form a corporation’, the first category above, affected the juridical status of the entity. Thus, dissolution for failure of the underlying agreement might have had a retroactive effect leaving creditors of the defective entity to share with personal creditors of the shareholders in the remaining assets of the defective entity on a non-preferred basis.¹⁵⁷ In contrast, the long held German

¹⁵⁰ Id.

¹⁵¹ The Commercial Code, Art 308(1), emphasis mine.

¹⁵² Id Art 323(1) and 223.

¹⁵³ L. Backer, Comparative Corporate Law, Op cit 686.

¹⁵⁴ R.M.Buxbaum, ‘Formation of Marketable Share Companies’, in A.Conard (ed), International Encyclopedia of Comparative Law, Op cit 26.

¹⁵⁵ K.Geens and B. Servaes, ‘Corporations and Partnerships in Belgium’, International Encyclopedia of Laws, Op cit 61.

¹⁵⁶ R.M.Buxbaum, ‘Formation of Marketable Share Companies’, in A.Conard (ed), International Encyclopedia of Comparative Law, Op cit 26.

¹⁵⁷ Id.

approach, also adopted in some other countries, did not give similar effect to consensual errors on the side of parties that have subscribed shares in the company. Such errors did not result even in the avoidance of the payment duty in respect of his/her contribution on the part of such subscriber once the company has been formed. In other words, a person who subscribed owing to fraud would still be required to pay what s/he 'promised' to contribute.¹⁵⁸ After the 1969 revision even the French statute eliminates the annulling effects of these contractual defects. The modern tendency is to prevent defective formation of either type from affecting the juridical status of the entity unsettling the expectations of third parties in good faith. The consequence of defective formation is, therefore, either calling on the company to rectify the problem or resulting in dissolution and winding up of the entity, not retroactive nullity. In deed, this is specifically provided for in most statutes.¹⁵⁹

Under Ethiopian law no valid contract can exist unless parties capable of contracting have given their consent sustainable at law, the object of the contract is sufficiently defined, is possible and lawful.¹⁶⁰ So, in the Ethiopian context defects pertaining to these could, perhaps, be regarded as defects of the first category, i.e. defects pertaining to the 'agreement to form a corporation' Examples of defects under this category are, therefore, vices in the consent of founders or/and subscribers like duress, fraud or mistake and lack of the requisite legal capacity.¹⁶¹ Arguably, the seven requirements like minimum number of members, minimum initial capital, full subscription of capital etc...discussed under section 3 above fall under the second category of defects, i.e. the 'formal' or 'technical' defects.

The Commercial Code of Ethiopia has only one article dealing with defective formation and its consequences. It provides, "where the share company is entered in the commercial register it will have legal existence and personality even where some legal requirements for the formation of the company have not been fulfilled."¹⁶² Where the non-compliance with the formation requirements endangers the interest of creditors or shareholders, the court may, upon the application of such creditors or shareholders, order the dissolution of the share company or take provisional measures it deems proper.¹⁶³ The court is barred from considering a tardy application. Such application should be made within three months from registration.¹⁶⁴

From the foregoing, one notes that the law does not classify defects in formation into defects pertaining to 'agreement to form a company' or contractual defects and technical or formal defects. It simply says defects in formation will have no consequence on the legal existence or personality of the company once it is registered. So, one may contend that neither type of defect will have retroactive effect of annulling the company, and the transactions entered into by it. The law expressly provides that shareholders or creditors

¹⁵⁸ Id. 27.

¹⁵⁹ Id. 28.

¹⁶⁰ Commercial Code Art 1 cum Civil Code Arts 1678. See also G. Krzczunowicz, Formation and Effects of Contracts in Ethiopian Law Op cit 57.

¹⁶¹ Commercial Code Arts 307, 3016-322 and Civil Code Arts 1696-1710.

¹⁶² Id. Art 324(1).

¹⁶³ Id. Art 324(2).

¹⁶⁴ Id. Art 324(3).

affected by defects in formation can apply for *dissolution* (Emphasis mine). This implies that creditors of the company as well as the shareholders themselves will have the kind of rights they have in the said process, i.e, dissolution.¹⁶⁵ So, it may be contended even a person who joined the company under duress will have to make the 'promised' contribution to the extent that is required by the interest of third parties in good faith.¹⁶⁶ Of course, s/he will have recourse against the party at fault for the resultant damage. In effect, this means the Ethiopian law is in line with developments in other jurisdictions when it comes to the consequence of defects in formation on third parties in good faith. Though it seems courts have not entertained sufficient number of cases pertaining to this issue to warrant making conclusions¹⁶⁷, there are indications showing a proper understanding of the law on the matter. For instance, in the case between the National Bank of Ethiopia and Horn International Bank Share Company, the court confirmed the revocation of business license by the National Bank, which was issued on the basis of false evidence, according to the National Bank. It then instructed the liquidator to pay creditors of the bank from the proceeds of the sale of its assets though the issuance of the license and hence the formation was found defective¹⁶⁸. It did not rule that the defect has retroactive effect of annulling the company and the transactions entered into by it. The court rather acknowledged the need to protect the interest of third parties in good faith. A problem in regard to defective formation is that the law does not provide a list of defects that warrant dissolution and those that do not, hence leaving the courts with no guidance.

Conclusions and Recommendations

Fraudulent or careless practice in the formation process of a share company can undermine the financial solidity of the company. What is worse, such practices jeopardize the legitimate interests of future creditors. Cognizant of this, the law in Ethiopia provides some safeguards. By and large, these safeguards resemble those provided in the Continental European legal tradition and are in keeping with current standards and trends. There are a few points with respect to which revision is warranted though. Those that stand out follow:

1. The reasons for requiring minimum initial capital are twofold. The first is preserving creditors from becoming involved with companies that are financially too frail. The second is to prevent investors from choosing to form a share company when it is too cumbersome and expensive for their intended operations. The minimum initial capital of 50,000 Birr, which the Ethiopian law requires to this end, can achieve neither of the purposes above today. Hence, there is a need to either increase the amount to reflect the current reality or follow the alternative mechanism used in the USA, according to which, the company is simply required to be 'adequately capitalized', subject to consequences where it is found to have been too thinly capitalized.

¹⁶⁵ Id. Arts 501,504(1),505.

¹⁶⁶ Id Art 499(4).

¹⁶⁷ Interview with Ato Yossief Aemro, Judge at the Federal High Court, On February 26,2008

¹⁶⁸ National Bank of Ethiopia v Horn International Bank Share Company (Civil File No 58/92, Federal High Court, Ginbot 24 1992 EC) (Unpublished)

2. In an organization like a share company where the liability of members is limited to their contributions, the contribution of members is instituted as much in the interest of creditors as in that of other members and the business firm itself. Hence, there is a need to take particular care to ensure that a contribution by a person does not jeopardize the interest of all stakeholders and especially that of the creditors of the company. In this regard, contributions in kind are cause for concern in Ethiopia.

2.1. The first is that in regard to the usefulness of contributions in achieving the business purpose of the company. Accepting contributions in kind which are manifestly useless jeopardizes the success of the company. This in turn exposes creditors to greater risk than anticipated, as the company will generate little wealth to be used for discharging its financial obligations. Yet, the Ethiopian company law is silent on the issue of usefulness of contributions in kind. As a result, there is no mechanism meant to ensure the usefulness of contributions, in the formation process. Hence, requiring the founders to file a report on the usefulness of contributions in kind, as under some other jurisdictions, seems appropriate.

2.2. The second problem is that in regard to contribution of service. Unlike in some other jurisdictions, contribution of service is not expressly prohibited in Ethiopia. In fact, it may be argued that contribution of past services, unlike future services, does not jeopardize the legitimate interest of stakeholders. Hence, it would be good if the law took clear stand on this.

2.3. The third problem in relation to contributions in kind pertains to their submission and valuation. Previously, the law required that contributions in kind be valued by disinterested experts from the Ministry of Trade and Industry. This requirement has been scrapped. The agreement of founders or members of the company as to the value of the contributions in kind has substituted this method. All that the new law requires is that founders, and where the company is formed by public subscription, subscribers agree on the worth of contributions made in kind.

This system is fraught with problems. For one thing, it might be impractical where there are a large number of shareholders with small investment each. What is worse, shareholders might deliberately overestimate the value of the contributions of each member in a bid to enhance the creditworthiness of their company by inflating its capital. In some cases, things could get much worse than that. An 'agreement' might be made to 'contribute' property that does not exist or does not belong to the 'contributing' member. This is possible because the notary before whom the memorandum of association is to be signed is required by law to ascertain the right of the contributing member to transfer the property, only with respect to contributions made to transfer property for which title certificates are issued under the law.

So, there is a need to explore ways of getting around the problems that necessitated abolishing valuation by disinterested experts, which presumably are lack of experts in sufficient numbers and the resultant delays in company formation. One possible solution is outsourcing this, instead of relying on employees of the Ministry. Another is introducing valuation as a business. The Ministry could license and supervise firms that engage in valuation as their business. If this does not succeed, one should perhaps think along the

lines of the law on private limited companies, i.e., make members of the company jointly and severally liable for the valuation fixed as under Art 519(1) and (2).

3. Yet another area in which the law seems to have shortcomings pertains to absence of guidelines as to defects in formation that warrant dissolution. One notes that the law in Ethiopia does not classify defects in formation into defects pertaining to ‘agreement to form a company’ or contractual defects and technical or formal defects. It simply says defects in formation will have no consequence on the legal existence or personality of the company once it is registered. So, one may contend that neither type of defect will have retroactive effect of annulling the company and the transactions entered into by it. In effect, this means the Ethiopian law is in line with developments in other jurisdictions when it comes to the consequence of defects in formation on third parties in good faith.