Preferred Shares under Ethiopian Company Law: The Ignored Vehicles of Corporate Finance?

Assefa Aregay Sefara[*]

Abstract

There is growth in the number of share companies in present day Ethiopia. Generally, companies fund their operations from different sources. Equity financing and debt financing are the prominent ones. Ordinary shares and preference shares form the equity financing form of the corporate financing. Yet, in Ethiopia equity financing is dominated by the basic security forms (ordinary shares) and preference shares are underutilized. This article examines how the Ethiopian company law treats preference shares.

Key words: Corporate finance, Ethiopian company law, preference shares, ordinary shares

1. Introduction

The legal regime governing Company Law in Ethiopia consists of the 1960 Commercial Code and other complementary and/ or sector specific laws. The Commercial Code contains legal concepts mainly borrowed from the continental European legal codes. Rules on corporate financing are amongst the norms brought to Ethiopia by the promulgation of the 1960 Commercial Code. A study is underway for the complete revision of the 1960 Commercial Code, but as of today no new Commercial Code has been adopted and the 'old' Commercial Code is still in force.

Writing on the subject of reception of western laws and legal institutions in Ethiopia one author suggested that unlike the areas of family relations, successions and land-holding systems, the commercial laws could be better absorbed in Ethiopia as there were no customary laws in that field.[1] He correctly observed the dearth of rules on commercial matters compared to the diverse customary rules in the areas of personal relationships and land-holding system at that time. The author's observation remains agreeable even decades later with

[*] *LLB (Hawassa University), LLM (University of Oslo), LLM (Central European University), Lecturer & Educational Quality Enhancement and Assurance Team Leader, Ambo University School of Law.*

[1] John. H Beckstrom, *Transplantation of Legal systems: An early report on the Reception of Western Laws in Ethiopia*, 21 THE AMERICAN JOURNAL OF COMPARATIVE LAW 557, 561 (1973).

regard to the adoption and practice of business concepts such as preference shares.

The absorption of imported commercial norms in Ethiopia has taken longer time than predicted. Different factors account for this problem. In the first place, the level of economic development of Ethiopia and the donor countries (from where the rules were imported) was so dissimilar. Ethiopian business community at that time was unfamiliar with the foreign commercial legal concepts. The Imperial Government started implementing the Commercial Code despite unfamiliarity with the rules. What is worse, with the downfall of the Imperial Government in 1974 the application of the Commercial Code was practically suspended. The 'communist' government that succeeded the Imperial Government abolished private ownership of property and share companies were rarely allowed. The application of the Commercial Code was restored following the collapse of the 'communist' regime in 1991. Consequently, share companies started to emerge in the business landscape and the rules of the Commercial Code including those governing corporate financing have become effective again.

Ethiopia has witnessed a growth in the number of share companies offering their shares to the public in recent years. The existing commercial laws allow share companies to fund their business through different tools such as equity securities, debentures and corporate bonds. The Ethiopian company law recognizes two forms of companies, i.e. share company and private limited company. Only share companies[2] are allowed to go public through the issuance of shares in the form of common shares, dividend shares or preference shares.[3] Whilst ordinary shares are widely utilized by share companies, the other tools of corporate financing such as issuance of preferred shares and debentures are uncommon in Ethiopia.[4] That means share companies stick to the basic form of equity financing (ordinary shares) despite the recognition of other tools of corporate financing. This is attributable to the low development of the financial market in Ethiopia.[5]

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[2] Owing to the legal limitations, simplicity of the requirements for formation and management, private limited companies are not suited for large scale investments. This is evident from the possibility of setting a private limited company between members of a family or close friends, the small amount of minimum startup capital required and the prohibition by the Commercial Code of private limited companies to engage in advanced form of business activities such as banking and insurance

[3] Art. 335, Art. 336 and Art. 337 of the Commercial Code of Ethiopia.

[4] ፍቃዱ ጴጥሮስ፣ <u>የኢትዮጵያ ኩባንያ ሕግ</u> (2ኛ ዕትም፣ 2008), ገፅ 102.

[5] *Id.*

Besides, the legislation regulating banking and insurance share companies in Ethiopia have adopted preferred-shares-unfriendly approach by requiring financial share companies to issue identical shares only in the form of ordinary shares.[6]

The concepts of corporate governance and corporate finance in Ethiopia are relatively new. Consequently, the level of familiarity with and expertise in financial securities in the country is low. It is generally assumed that the business lacks experience and expertise in administering diversified shareholders with different classes of shares. The chosen way out is then simply to issue identical classes of common shares with identical rights and avoid other security forms such as preference shares. This trend has an unintended consequence of perpetuating dominance of the basic security forms.

This article examines the position of Ethiopian commercial laws regarding preference shares. Preceded with a slight detour into a discussion of corporate financing in general, an examination of the role of preference shares in the start-up businesses and the common features of preferred shares follow.

2. Corporate Financing – Some Basics

A group of people with a similar business idea can come together to venture in business by bringing together contributions in cash and/or in kind and form a business firm. At the stage of capital formation, a firm has two options to raise capital. If founders want to collect a huge capital from interested investors, they offer shares to the public. Consequently, the ownership interest will be distributed to the public via shares. Alternatively, if they want their firm to be closely held by them, they do not go public. In that case, after successfully establishing their company and securing its legal personality, they may turn to lenders than distributing their company's ownership interests to investors in the form of securities.

2.1. Internal vs External Sources of Finance

Generally the sources of capital for companies could either be internal, i.e. contributions brought together by the founders, from earned and retained profits,

[6] Art. 10(1) of the Banking Business Proclamation No. 592/2008 states: 'bank shares shall be of one class and shall be registered as ordinary shares of the same par value'. Comparable restriction is imposed on insurance companies under Art. 11(1) of the Insurance Business Proclamation No. 764/2012.

and external sources.[7] The external sources include loans from banks or other financial institutions, debt-financing instruments (such as corporate bonds and equity financing instruments (such as common stocks and preference stocks).[8]

An important external source of finance for a company is issuing securities to interested investors.[9] This constitutes 'equity capital financing either in the form of shares or in other equity rights'.[10] Equity securities represent the investors' ownership interests in companies. Whilst they carry slightly different nomenclatures from jurisdiction to jurisdiction, different equity securities bring with them different packages of rights, privileges and duties.

The Ethiopian Commercial Code recognizes three forms of equity securities, i.e., ordinary shares, preference shares and dividend shares.[11] Preference shares and ordinary shares are the major forms of equities issued by companies. Both classes of shares endow legal rights such as income rights (right to payment of dividend), voting rights and capital rights (right to the return of capital in case of reduction of capital or on a winding up) upon their holders.[12] Common stocks endow their holders with identical packages of ownership interests[13], whereas preferred stocks may come in different forms and terms depending on the company's statutes and terms of the share sale contract.[14]

The other category of the external sources of fund for companies is borrowing money from banks and other financial institutions (debt capital financing).[15]

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[7] Michael Martinek, *Law and Economics of Corporate Finance in Europe - From Diversity to Convergence and Harmonization*, 2008 J. S. AFR. L.16, 16 (2008).

[8] *Id.*

[9] Companies grant bundles of ownership interests (rights) called securities in exchange for money.

[10] Martinek, *supra* note 7.

[11] Arts. 335, 336 and 337 of the Commercial Code of Ethiopia.

[12] Murray A. Pickering, *The Problem of the Preference Share*, 26 THE MODERN LAW REVIEW, Sept. 1963, at 1, 1.

[13] See also Art. 345 of the Commercial Code Ethiopia. This provision recognizes the shareholders' *income rights* (right to payment of dividend which is calculated in proportion to the amount of capital held unless agreed otherwise), *voting rights, the right to share in the net proceeds on a winding up, and the right to allotment of cash shares on an increase of capital*. Common shareholders also have rights listed under Arts. 406, 417 and 422 of the Commercial Code.

[14] WILLIAM W BRATTON, CORPORATE FINANCE, 354 (Foundation Press, 5th ed. 2003).

[15] Martinek, *supra* note 7, at 16.

Debt financing occurs when firms take loan from banks or other investors and through issuing debt securities (bonds, bills or debentures) to investors.[16] Unlike the equity investors, debt investors are entitled to the fixed claim (interest payments) which could be secured or unsecured, but have a limited or no role in the governance of a corporation depending on the particular jurisdiction.[17] The Ethiopian Commercial Code recognizes corporate bonds as debt financing instruments.[18] Under the Commercial Code debentures - just like shares - are required to have par values and companies interested in selling debentures to interested investors should issue prospectus.[19] Owing to the low development of the financial market in Ethiopia it is not common to see companies utilizing debentures as an alternative means of financing their ventures.[20]

3. Use of Preference Shares by Start-ups

In capital markets, companies in their first stage of operation (start-ups) seeking to raise capital to satisfy their financial needs issue different financial securities to venture capitalists.[21] These start-ups are financially risky operations that deploy high-tech businesses such as internet and robotics. By their nature, these kinds of business ventures may be highly profitable[22] or may end up in vain. Thus, investors supplying funds to them want their money to be invested in the form of preferred shares. 'Development stages companies are busy consuming capital, not earning profits, and do not anticipate being able to pay dividend until after the business becomes profitable'[23] Thus, investing in start-ups involves assuming a high financial risk by the venture capitalists. That is the primary reason that

[16] *Id.* Debt capital financing is in a way advantageous to the issuer firm in many ways. To mention some, debt financing providers in most jurisdictions have no say in the management of the company. Besides, the issuer is not going to share a profit with the investor which is not the case with the equity financing providers.

[17] Martinek, *supra* note 7, at 16.

[18] Arts. 425-444 of the Commercial Code.

[19] *Id.*, Arts. 433 and 434.

[20] Fekadu, *supra* note 4.

[21] Investopedia defines venture capitalist as 'an investor who either provides capital to startup ventures or supports small companies that wish to expand but do not have access to equities market'. They are referred to in the literature as 'angels'.

[22] Internet bookseller Amazon.com and internet auction portal eBay are examples of such companies.

[23] WILLIAM J. CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICES 452 (Foundation Press, 2005).

makes investors to demand privileges over ordinary stockholders through the preferred stocks arrangements. In other words, unlike common stockholders, venture capitalists do not want to be rewarded proportionate to their investment.[24] They rather choose to receive 'a greater than proportionate return, priority in receiving a return, or both'.[25]

As it will be shown later, the packages of privileges for preference shares emanates not from corporate laws but from preferred stock contract.[26] To reach at preference shares contract the investors negotiate with founders of start-ups. When a share purchase negotiation is successful, venture capitalists put a huge amount of money into a firm in return for preference arrangements. Yet compared to common stocks and bonds, preference shares constitute a smaller portion of most companies' total equities.[27] As it is the case with many emerging economies, the practice of funding start-ups by venture capitalists appears absent in Ethiopia.

4. Features of Preference Shares

As earlier noted, preference shares are contractual creations and not something imposed by corporate laws. Pursuant to the rule of parity among shareholders, absent special agreement with some shareholders, the rights and privileges of all shareholders are equal.[28] According to Buxbaum 'there is no ideal preferred stock but only a collection of attributes which the share contract says makes up a share of preferred stock.'[29] 'The share contract, in turn, is found in the articles of incorporation and the applicable statutes.'[30] Preference shareholders are also shareholders, after all, and are entitled to all the rights of the common shareholders except as modified by preferred share sale contract. However, preference shares as 'collection of attributes' created by contract also contain

[24] ERIC A. CHIAPPINELLI, CASES AND MATERIALS ON BUSINESS ENTITIES 154 (Aspen Publishers, 2006).

[25] *Id.*

[26] Bratton, *supra* note 14, at 355.

[27] *Id.*, at 354.

[28] George William Miller, *Preferred Shares: Participation Rights in Dividends and Surplus Assets: English and American Rules*, 39 CALIFORNIA LAW REVIEW 568, 568 (Dec.1951).

[29] Richard M. Buxbaum, *Preferred Stock: Law and Draftsmanship*, 42 CAL. L. REV. 243, 243 (1954).

[30] *Id.*

additional packages of privileges for its holders.[31] For instance, a preference share may give its holder a preferential claim to dividends or corporate assets upon liquidation.[32] Thus, compared to common stockholders, preferred stockholders have a greater claim to the company's assets - they have priority in receiving the percentage of dividends indicated in the articles of incorporation.[33] If the company goes bankrupt, they are paid off before common stockholders, but after creditors. In other words, holders of preference shares have liquidation preference.[34] In addition to determining the offered packages of privileges, a preferred stock clause also details the limitations or restrictions imposed on holders.[35]

As they emanate from contractual stipulations, the preference rights of preference shareholders are determined by active bargaining between such shareholders and the issuing company. Corporate membership rights such as voting rights and representation in the corporate board may or may not be available depending on the jurisdiction concerned.[36] For instance, under Delaware State's (in the USA) corporate law, preference shareholders are, in addition to the preferences, entitled to the residual rights as any other shareholders.[37] Yet limitations to these residual

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[31] In principle, preferred stocks are created by the preferred stock clause of the preferred stock contract (the preferred stock clause of the articles of incorporation).

[32] BLACK'S LAW DICTIONARY (9th ed. 2009).

[33] Compared to common shares, preference shares are entitled to the fixed dividend payments. In cumulative preference shares dividend is paid regularly. If for some financial reasons an issuer company fails to pay out the dividends for some period the arrearages are owed and should be paid back when the company regains the dividend payments. This puts preference shareholders at significant advantages over common shareholders. Yet they might not be able to share the excess profit depending on whether the preference shares are participating or non-participating. Creating preference shareholders that are both cumulative and participating puts its holders at the utmost advantage over common shareholders. Thus the nature of preference shares a company issues should be carefully decided as it may create a huge imbalance of rights between common shareholders and preference shareholders.

[34] Black's Law Dictionary (9th ed. 2009) defines liquidation preference as 'the amount of money that constitutes the full satisfaction of the preferred's fixed claim.

[35] Bratton, *supra* note 14, at. 357

[36] *Id.*

[37] Art. 151(a) of Delaware Corporation Law states:

Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights could be provided in the certificate of incorporation or resolution of the board of directors.[38]

The principle that preference shares are created contractually is applicable in Ethiopia. There is no clear reference to share sale contract under the Ethiopian Commercial Code. Art. 336 (1) of the Commercial Code states that preference shares are created either in *the memorandum of association or by resolution of an extraordinary general meeting*. The potential contents of the preference package in the memorandum of association or the resolution of an extraordinary general meeting authorizing issuance of preference shares include, 'preferred right of subscription in the future issues, or rights of priority over profits, or assets or both'.[39]

Art. 336(2) of the Commercial Code however prohibits share companies from issuing preference shares with increased voting rights. This prohibition is in line with the classic corporate law principle of *one share one vote* embodied under Art. 345 of the Code. The Commercial Code states that voting right of shareholders is a right inherent in corporate membership which a member cannot be deprived without his consent.[40] In addition, Art. 408 of the Commercial Code prescribes that all shares should carry equal voting rights and if there is a restriction it should be applicable to all classes of shares irrespective of their designation. Art. 410 of the Commercial Code even goes to the extent of invalidating any provision restricting the free exercise of voting rights in shareholders meetings. Furthermore, it is the right of any shareholder to take part in ordinary meetings regardless of any restriction to the contrary.[41] So it appears from the cumulative reading of these provisions that it is in principle prohibited to deny preference shareholders' voting rights in ordinary general meetings. Yet the voting rights of shareholders with preference rights in sharing profits and

rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.

[38] *Id.*

[39] Art. 336 (1) of the Commercial Code.

[40] *Id.* Arts. 388 and 399.

[41] *Id.*, Art. 420.

distribution upon dissolution of a company may be restricted (in ordinary general meetings) through a company's memorandum of association.[42]

The scope of preference shares in principle extends to any share that possesses rights or privileges that differ from the statutory defaults, i.e. one-share one vote; equal shares of dividends. This may create an increased unpredictability into the very definition of the preferred stock.[43] Of course preferred shares can be denied of their voting rights. The prohibition in a way protects the common stockholder from dilution of voting rights thereby maintaining their control over the management and also protecting their company from hostile takeovers.[44] Common shareholders exercise their voting rights in important corporate matters such as the election of the board of directors and decisions regarding major company policy. Nevertheless, when it comes to payment of dividends, they do not enjoy priority.[45]

Preference shares come in different forms and/or classes. For instance, the issuer company can issue preferred shares either on cumulative or non-cumulative basis. Cumulative preference share 'has a fixed dividend based on the par value of the stock'.[46] In principle, the dividend is paid regularly for cumulative preferred stocks. However, if for some economic difficulties an issuer company fails to pay out the dividends for some period, the payments left unpaid (arrearages) are owed and should be paid back when the company regains the dividend payments. As long as the dividends on the preference shares remain in arrears, a company may not make dividend payments on ordinary shares. For non-cumulative preferreds, the holder is not entitled to the omitted dividends. Investors naturally demand the cumulative preferred shares to the non-cumulative ones. The Ethiopian Commercial Code does not indicate whether this category is recognized or not. In the opinion of the writer it is up to the concerned share

[42] *Id.*, Art. 336 (3).

[43] Charles R Korsmo, *Venture Capital and Preferred Stocks*, 78 BROOK. L. R. 1165, 1171(2013).

[44] A hostile takeover is the purchase of one company by another made by going directly to the company's shareholders or fighting to replace management to get the acquisition approved. It is possible through either a tender offer or a proxy fight.

[45] Common stockholders receive dividends, only after the preferred stockholders are paid off. Furthermore, they are the last to receive the company's assets in the event the company goes bankrupt. They are preceded by the creditors, bondholders and the preferred stockholders.

[46] 'Cumulative preferred stocks' INVESTOPEDIA (Sept. 08, 2017), https://www.investopedia.com/terms/c/cumulative_preferred_stock.asp

company whether to issue cumulative or non-cumulative preference shares so long as its right to issue preference shares is recognized.

Preference shares can also be participating or non-participating. Participating preference shares refer to shares that bring the agreed share of dividend or liquidation bonus as well as equal participation in the remainder with the common shareholders. In contrast a non-participating preference shareholder forgoes her/his right to partake in distributable assets beyond a fixed rate.[47] Cumulative and participating forms of preference shares give a supreme economic advantage to the preference shareholders than to the non-cumulative or non-participating counter parts. Conversely, they pose bigger disadvantages to the holders of common shares. The Ethiopian Commercial Code does not clearly indicate the category of preference shares into participating and non-participating. The opinion noted above in relation to cumulative versus non-cumulative preference shares also applies to participating and non-participating forms of preference shares, i.e. so long as the share company's right to issue preference shares is recognized it's up to it to issue participating or non-participating preference shares. Yet it is important to clearly provide whether the preference shares are participating or non-participating in the memorandum of association or the resolution of shareholders' extraordinary general meeting.

Another feature of preference shares developed lately is the inclusion of the so called 'sinking fund provision'. This provision determines how the issuer company can call back the preference shares overtime by paying them off (amortization). This in a way creates an implied maturity date for the preference shares.[48]

In summary, preference share combines some features of debt securities with some of the features of equity.[49] It shares some features of debt financing documents such as debentures/corporate bonds. A preferred resembles a corporate bond in being the senior security that earns its holder regular payments. Yet, preference shares are grouped with ordinary shares on the balance sheet in the shareholders equity section, while debentures and bonds show up as a liability.[50] Because of its hybrid character 'the legal treatment of preference

[47] Miller, *supra* note 28, at 569.

[48] It is customary for corporate bonds to have a maturity date.

[49] Korsmo, *supra* note 43, at 1165.

[50] Bratton, *supra* note 14, at 354.

shareholders has long straddled the dividing line between corporate law and contract law'.[51]

5. Preferred Shares under Ethiopian Company Law

5.1. *Art. 336 of the Commercial Code*

As stated above, shares of share companies in Ethiopia can take different classes, notably: preference shares and common shares.[52] Different classes of shares confer different rights, duties and privileges upon their holders. The preference shares confer upon its holder a priority on the annual profits in the form of cumulative or non-cumulative preference dividends or the preferential dividend right upon the liquidation of the company or simply the right to receive the liquidation bonus. A probe into the nature of preference shares under Ethiopian company law begins with Art. 336(1) of the Commercial Code which states:

> A share company may create preference shares either *in the memorandum of association or by the resolution of an extraordinary general meeting.* Such shares enjoy a preference over other shares such as the preferred rights of subscription in the event of the future issues, or rights of priority over profits, assets, or both. (Emphasis added).

As can be understood from this authorizing provision, once a share company decides to issue preference shares, the provision to this effect must be inserted in a memorandum of association or ordered by a resolution of the extraordinary meeting of shareholders. The law recognizes preference shares by utilizing a permissive legal norm. As a result, it is up to the concerned share company to issue or not to issue preference shares. As preferred shares provide their holders with privilege(s) distinct from that of common shareholders' it is necessary to determine the contents/scope of preference arrangement under the Ethiopian Commercial Code. Art. 336(1) shows that preference shareholders might be entitled to the packages of privileges (preferences) such as the subscription of new shares, the right of priority in share of profits and/or liquidation bonuses.

Art. 336 of the Commercial Code seems to allow a share company to issue different classes of preference shares with different packages of rights. For instance a share company can issue some portion of its shares as cumulative preference shares only (priority in dividend), non-cumulative preference shares only (priority in dividend), participating preference shares (priority in dividend

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[51] *Id.*

[52] Arts. 335, 336 and 337 of the Commercial Code.

and/or liquidation assets), and non-participating preference shares (priority in dividend and/or liquidation assets).[53] It is also a possibility for preference shares with priority in collection of profits to be cumulative and participating, non-cumulative and non-participating or cumulative and non-participating. Preference shares with a priority in the collection of liquidation assets can only be participating or non-participating.[54] For example, a share company with 5000 shares can issue 200 shares with a priority in collection of liquidation asset of 20% and participating. In this case the preference shareholders will first share 20% of the assets and take part, pro rata with their shares, in the partition of the remaining 80% with the common shareholders provided that there are no other third parties with priority of claims. If the preference to liquidation asset is non-participating, its shareholders will take only the fixed percent (20%) and cannot participate in the remaining assets with common shareholders.

Unlike the recognition of priority in cases of dividend (profit) and/or liquidation of assets, the law is not clear when it comes to the package of preference share recognized under Art. 336 of the Commercial Code, i.e., 'priority in form of subscription of new shares'. Art. 470 of the Code states that preferred right of subscription in case of issuance of new shares belongs to all shareholders. The literal reading of this provision may seem to guarantee priority of subscription to shareholders against the new investors (other than the existing shareholders). By this interpretation, it would have been possible to read Art. 470 to bestow on preferred shares right of 'priority in form of subscription of new shares' in line with Art. 336. But a stronger prohibition is provided under Art. 475 of the Commercial Code that disallows issuance of 'documents conferring special preferred rights of subscription'. If the term 'documents' utilized under Art. 470 is interpreted as preference shares authorizing 'priority in form of subscription of new shares', then 'priority in form of subscription of new shares' under Art. 336 cannot form part of the package of privileges of preference shares.

But, this writer contends that the package of privileges enumerated under Art. 336 is not exhaustive. Thus, the issuing share company can, in theory, provide preference(s) or contractual protections not stated under Art. 336 of the Commercial Code either in a corporate charter or via a resolution of the

[53] See section 4, above, for a general discussion on cumulative vs non-cumulative, participating vs non-participating shareholders.

[54] This preference in the collection of liquidation of assets cannot be categorized as cumulative vs non-cumulative as a company winds up only once and it's illogical to think the possibility of piling up of payments for preference shareholders of this class.

extraordinary meeting of shareholders. In the company laws of many jurisdictions, the scope of preference share is determined either in the authorizing corporate charter or in the resolution of an appropriate organ(s) of the issuing firm. Thus, exhaustively dictating the scope of preference shares does not seem to be the business of company laws. Similar position could be advanced in regards to the Ethiopian Commercial Code.

Nonetheless, although the packages of privileges for preference shares are determined by negotiations between the issuing company and preference shareholders, they are not without restrictions. One of the legal restrictions under the Ethiopian Commercial Code relates to voting rights. The law prohibits issuance of shares with 'a preference as to voting rights'.[55] It is by no means allowed to include preference as to voting rights via conferment of increased voting rights upon preference shares. Thus, increased voting rights cannot form part of preference packages authorized by a corporate charter or via a resolution of the extraordinary general meeting of shareholders.

One may wonder if preference shareholders can take part in the management of their company. Participation in the management of firm is normally manifested by participation in general meetings and representations in the board of directors. The general rule under Ethiopian Commercial Code is that, every share confers a voting right.[56] So a simple answer to the question is: yes preference shareholders can take part in the management of their company as the rules of the Commercial Code stand. The prerequisite to be appointed as a member of board of directors is to be a shareholder.[57] By this formula nothing prohibits a preference shareholder of a share company from being appointed as a director. The relevant provisions of the Commercial Code also reveal that preference shareholders, in principle, have the right to take part in corporate meetings and vote on important corporate matters just like the common shareholder. In many jurisdictions the issuance of preference shares enables common shareholders to retain their control over the corporate management, make decisions on important corporate matters and fight hostile takeovers as well. This position can also be true under the Commercial Code of Ethiopia, if a memorandum of association of a share company creating preference shares restricts the voting rights of preference shareholders to the matters concerning extraordinary meetings as per

[55] Art. 336 (2) of the Commercial Code.

[56] *Id.* Art. 345(3).

[57] *Id.* Art. 347.

Art. 336 (3) of the Commercial Code. The restriction of preference shareholders voting rights in ordinary general meeting helps to avoid the possible class struggle between the common shareholders and preference shareholders.[58] It is obvious that the class struggle between the two could result in difficulties in the management of the company and result in potential failure.

The conferment of equal voting rights for preference shareholders and ordinary shareholders may leave the ownership interests of the latter in a serious condition. To avoid this predicament, the law has devised a means by which the voting rights of preference shareholders could be sometimes limited in the memorandum of association.[59] Consequently, preference shareholders will not vote in ordinary general meetings and resolutions approving or rejecting the accounts for the past financial year, allocating or distributing profits, appointing or removing auditors or directors and decision on any matter other than those reserved to extraordinary general meeting will be passed without the vote of preference shareholders.[60] Art. 424 seems to indirectly confirm the possibility of denying preference shareholders' voting rights (in ordinary general meetings) by inserting a provision to that effect in the memorandum of association. Art. 424 states, thus, 'any shareholder, including preference shares holders may take part in an extraordinary meeting'.

5.2. Modes of Authorization of Preference Shares

As broadly alluded to earlier, the two modes of authorizing preference shares under the Commercial Code are a clause to this effect in the memorandum of association[61] and a resolution of the extraordinary general meeting of shareholders.[62] The paragraphs below elaborate these two modes.

[58] Fekadu, *supra* note 4, at 100.

[59] Art. 336 (3) of the Commercial Code Ethiopia. Besides, sub-article 4 of the same article restricts the number of shares having restricted voting rights not to exceed half the amount of the capital.

[60] *Id.*, Art. 419.

[61] Memorandum of association is a company's public document prepared at the formation stage that should contain relevant information about the future share company as per Art. 313 of the Commercial Code. Together with the articles of association, they form the foundation documents of a company.

[62] Art. 336 of the Commercial Code.

The general laws applicable to share companies provide a possibility for share companies to issue preference shares in their memorandum of associations.[63] Pursuant to Art. 313 of the Commercial Code having a memorandum of association is mandatory for a company.[64] Art. 313 (6) states that the memorandum of association shall, among other things, contain 'the par value, number, form and classes of shares'. Accordingly, a memorandum details if registered or bearer shares are allowed as well as the classes of shares to be issued. This mode of authorization gives shareholders an opportunity to vote on the specific preference packages to be included in preferred shares. Nonetheless, if special laws prohibit issuance of preference shares by certain types of companies, such companies cannot include preference shares in their memorandums of association. This concerns financial share companies and it will be dealt with under a separate section below.

The second technique embodied under the Commercial Code to create preferred shares is by the resolution of extraordinary general meetings of shareholders. One amongst the agenda of the extraordinary general meeting of a share company is approving increase in their investment and making amendment to the memorandum of association.[65] The amendment may target provisions of the memorandum governing preference shares.

If the original memorandum of association has not incorporated preference shares, the resolution of extraordinary general meeting can in principle amend it and incorporate one. The amended memorandum should then be deposited at the commercial register pursuant to the relevant rules governing the registration and licensing of share companies. Should the company decide to go public again, the new prospectus that should include amendments to the original memorandum should be available to interested investors (including those who want to become preference shareholders). Here it is worth mentioning that the amendment to the memorandum of association of some share companies require license/permission from the concerned governmental regulatory agency. For

[63] *Id.*, Art. 336(1). The French Commercial Code under its Art. 228(1) also states that the privileges that the preference shares can enjoy should be stated in the articles of incorporation. The American Model Corporation Act (MBCA) section 6.01(a) also incorporates similar provision.

[64] The same is reflected under Art. 5(6) of the Commercial Business Registration and Business Licensing Proclamation No. 980/2016.

[65] Art. 423 cum. Art. 425 of the Commercial Code.

example, the amendment of the statutes of banks and insurance companies require approval by the Ethiopian National Bank.[66]

5.3. Limitation on Financial Share Companies

The general rules of the Commercial Code governing issuance of preference shares examined above are inapplicable to banks and insurance companies operating in Ethiopia.[67] It is pointed out above that only companies incorporated in the form of share company are allowed to invest in the banking and insurance businesses.[68] Following the regime change in 1991, the government has allowed share companies to venture in the banking and insurance businesses with several investment limitations.[69] Concerning issuance of securities by banks and insurance companies, the law prohibits issuance of preference shares recognized under the Commercial Code. It instead, demands the issuance of the basic form of security, i.e., common shares. Art. 10(1) of the Banking Business Proclamation No. 592/2008 states 'bank shares shall be of one class and shall be registered as ordinary shares of the same par value'. Comparable restriction is imposed on insurance companies under Art. 11(1) of the Insurance Business Proclamation No. 764/2012. By doing so, these laws prohibit the utilization of dividend shares and preference shares by financial share companies, restricting the financial companies' access to fund collectable from issuing preference shares.

It is true that the legal requirements involved in the formation through operation of financial share companies are rigorous when compared to non-financial share companies. The government maintains a close watch over the financial sector.

[66] Art. 3(3)g of the Banking Business Proclamation No. 592/2008 and Art. 3(3)g of the Insurance Business Proclamation No. 764/2012.

[67] The Banking Business Proclamation No. 592/2008 and Insurance Business Proclamation 764/2012 with other relevant regulations and directives govern the banking and insurance businesses.

[68] That rule of course does not include the government owned banks and insurance companies that are not incorporated by strictly following the rules of the Commercial Code. They are instead established by Regulation of the Council of Ministers in the form of public enterprises. Their corporate finance and corporate governance does not appear to follow the model of the private (share) companies venturing in banking and insurance businesses.

[69] There are several investment limitations on banks imposed by several banking laws in force in Ethiopia. For instance, foreign direct investment in the banking sector is prohibited, limitations on the ownership of bank shares, limitations and control on the activities of banks themselves, limitations on the banks' ownership of other companies, the requirement of approval by the National Banks on the appointment of directors, installation of new banking services, amendment to its corporate charters and so forth.

The laws barring banking and insurance share companies from issuing preference shares are one of the many manifestations of this close control and supervision. These laws have the effect of totally banishing the option of issuing preference shares, which, of course, are ignored even by the non-financial share companies.

The practice in jurisdictions with reputable corporate law such as the State of Delaware shows that the financial institutions, insurance companies or other corporations subject to the strict capital adequacy regulations as illustrated by the size and composition of the preferred stock exchange -tradable funds, issue all kinds of public preferred stocks.[70] The concern of the Ethiopian state seems to be protection of the stability of the financial system and protection of shareholders as well as customers of these financial share companies - possibly by prohibiting the concentrated ownership of shares by a few shareholders and avoiding the issuance of advanced security forms such as preference shares by financial share companies. As the country has a limited expertise and fledgling 'capitalist' market and corporate governance system, the precautions and legal restrictions are arguably justified.

As discussed above, there are not that significant differences between preference shareholders and common shareholders. The general rules of the Commercial Code which are in principle applicable to both financial and non-financial share companies state that both classes of shareholders do have rights to be appointed in the board of directors. Both classes of shareholders have rights to take part in the corporate meetings and take part in important company decisions. The only possible difference especially in relation to the voting rights is the fact that Art. 336 (3) of the Commercial Code allows the insertion of clause in the memorandum of association restricting preference shareholders voting rights in extraordinary meetings of shareholders. Different reports show that banking and insurance share companies are profitable even compared to non-financial share companies. It is not clear why preference rights cannot be conferred on some shareholders so that potential investors will get strong incentives to invest in this young financial sector which is relatively unexposed to foreign competition. This position may have the unintended consequence of limiting the financial companies' access to capital and hamper their growth and expansion which will, in turn, impact their readiness to compete regionally and globally. A middle ground would have been possible by limiting a percentage of funds that financial share companies could fetch through issuing preference shares.

[70] Ben Walther, *Peril and Promise of Preferred Stock*, 39 DEL. J. CORP. L. 161, 163 (2014).

6. Conclusion

Companies obtain their funds from different sources. These sources include internal (mainly contributions by founders) and external (money collected from investors by issuing shares). Ethiopian company law recognizes private limited company and share company as two distinct forms of companies. It allows only share companies formed through public offering of share to issue shares to the public via prospectus. Shares under the Commercial Code could either be ordinary shares or preferred shares. Nonetheless, the practice on the ground reveals that the securities market is dominated by the basic security form (ordinary shares). In one way, issuing diversified forms of securities widens share companies' access to capital. It in fact may likewise install difficulty into the relatively inexperienced corporate governance and corporate finance system of the country. The well-known practice by newly formed share companies in Ethiopia is to issue ordinary shares to interested investors through prospectus. Shares are sold to the public through banks as commission agents.

Financial share companies are prohibited by the law from issuing preferred shares. However, the non-financial share companies have the freedom to issue preference shares. The writer is of the opinion that the policy and laws that prohibit financial share companies from issuing preference shares are misguided. Financial share companies should be allowed to meet their need for finance by issuing preferred shares as well. The concern of the government is the protection of stability of the financial system in general and the security of ownership interest of investors and customers of the financial share companies in particular. Yet it can accomplish these objectives by allowing financial share companies to issue preference shares under certain conditions. In general, the level of familiarity with preference shares as vehicles of corporate finance in Ethiopia seems to be low. This ignorance coupled with the government's mistrust of preference shares may have the effect of depriving share companies of the option of utilizing preference shares in Ethiopia.