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THE PROTECTION OF CORPORATE CREDITORS UNDER ETHIOPIAN SHARE COMPANY LAW IN LIGHT OF INTERNATIONAL RECOMMENDATIONS

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School of Law,
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October, 2020

THE PROTECTION OF CORPORATE CREDITORS UNDER ETHIOPIAN SHARE COMPANY LAW IN LIGHT OF INTERNATIONAL RECOMMENDATIONS

Thesis

Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Laws (LL.M.) in Business and Corporate Law Program at the School of Law, Bahir Dar University

By

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October, 2020

Thesis Approval Page

The thesis titled "The protection of corporate creditors under Ethiopian share company law in light of international recommendations" by Ms. TigistDessieKassa is approved for the degree of Master of Laws (LL.M.)

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Declaration

I, the undersigned, declare that the thesis comprises my own work. In compliance with widely accepted practices, I have duly acknowledged and referenced all materials used in this work. I understand that non-adherence to the principles of academic honesty and integrity, misrepresentation/fabrication of any idea/data/fact/source will constitute sufficient ground for disciplinary action by the University and can also evoke criminal sanction from the State and civil action from the sources which have not been properly cited or acknowledged.

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University Id. Number

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Date

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List of Abbreviation/ Acronyms/

AABE …………. …Accounting and auditing board of Ethiopia

Art…………………Article

DARA……………. Document Authentication and Registration Agency

EU………………… European Union

MOTI……………… Ministry of Trade and Industry

OECD……………. Organization for Economic Cooperation and Development

P …………………. Page

pp.…………………Pages

Proc.......................Proclamation

UK…………………United Kingdom

UNCITRAL ………. United Nations Commission on International Trade Law

USA………………. United States of America

Abstract

Incorporate form of business venture where the liability of the member is not beyond the amount of their investment, the protection of creditor has become a mandatory norm. Being the creditors of such limited liability companies by itself brought the risk of default payment as the creditors cannot look after the personal property of individual shareholder in order to meet their claims. As a result of this shield of limited liability, shareholders can be incentivized to act opportunistically towards its creditors by using the privilege that the limited liability granted them. Due to that, any framework sought for the protection of corporate creditors needs to consider the principle of limited liability as additional problem. Depending on the prevailing legal tradition, the protection of corporate creditors is provided either through the instrumentality of statutory legal provision incorporated in different legislation or through contract or also known as self-help mechanisms. This study tried to explore the protection of corporate creditors under the Ethiopia share company law in light of accepted international principles. Thus, this paper critically analyzes whether the Ethiopia share company law provides adequate protection for corporate creditors by using important principles such as OECD Principles of corporate governance and the doctrine of capital maintenance. To accomplish this task, the researcher employed qualitative legal research method by analyzing laws including the commercial code, financial reporting proclamation no 847/2014 and other relevant legislations. What is more, the researcher has also interviewed experts from MOT, Business licensing and registration institution, Addis AbabaUniversity, AABE and Document Authentication and Registration Agency. The main findings of the research are: the existing share company law is not adequate in protecting corporate creditors and to the worst, the draft commercial code does not rectify most of these problems identified. Hence the study found that, there is a poor mandatory disclosure regime in Ethiopia for the purposes of corporate creditor protection, those provision of capital maintenance does not adequately protect the rights of corporate creditors and the law also failed to incorporate those rules of protection which control the opportunistic behavior of directors in the near ofcompany's insolvency. Based on such findings, the researches recommend that the country need to revisit the Ethiopian share company law so as to adequately protect corporate creditors.

CHAPTER ONE: INTRODUCTION

1.1. Background of the study

Business activities can be undertaken in a variety of forms depending on different factors. With the main objective of facilitating commerce and investment, different country's law provide different forms of business organization. Hence the creation of a business organization is an important arrangement that enables people to do business which might be hard, or not unbearable, for them to do alone.[1] Among various types of business organization, companies are one form which enables engagement in large-scale economic activities with substantial resources characterized by these essential attributes. These include limited liability, transferable shares, delegated management under a board structure, and investor ownership.[2]

As literatures point out, the formation of companies in its modern legal structure is a recent phenomenon in Ethiopia.[3] In the current legal framework, companies are one form of business organizations recognized by the Ethiopian commercial code.[4] The legal regime which governs such a business organization is called company law also known as corporate law. In this paper, corporate mean company as defined under the commercial code of 1960. As far as the company's and their governance is concerned; there are two sets of rules of standard that applicable to share companies in Ethiopia. The first one is corporate governance rules apply to financial companies and the other one is the governance system applies to other companies' works on other economic activities.[5]All in all, the legal regimes govern all these companies include but not limited to: commercial code of 1960, the Banking Proclamation no 592/2008, and Commercial Registration and Business Licensing Proclamation no 980/2016, financial reporting proclamation no 847/2014.

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[1]NigusieTadesse, *Major Problems Associated with Private Limited Companies in Ethiopia*: the Law and the Practice, LLM thesis Addis Ababa University,2009 [unpublished available at law library], p. 1 (hereinafter NegusieTadesse, *Major Problems Associated with Private Limited Companies*

[2]ReinierKraakman et al, *The anatomy of corporate law: A comparative and Functional Approach*, 3rd edition, oxford university press ink, New York, 2017, p.5 [hereinafter, ReinierKraakman et al, Anatomy Of Corporate Law]

[3]Getahun, Seifu,, 'Revisiting Company Law with the Advent of Ethiopia Commodity Exchange' *Mizan Law Review* Vol. 4 No.1, March 2010, p 103[here in after, Getahune, Revisiting Company law]

[4] Commercial Code of the Empire of Ethiopia, 1966, NegaritGazzetta, Extraordinary issue, Proc. No. 166, 19th year, No. 3[here in after com. code]

[5]TewodrosMeheret, 'Governance of Share Company in Ethiopia', 2010, PP. 53-132,p.79 {here in after TewodrosMihrte, Governance of Share Company in Ethiopia}

Any business organization including companies needs financial resources for initiation, operation, and expansion of their business purposes.[6]Yet, the manner in which these business organizations satisfy their financial needs greatly varies from one to the other form.[7] Share Company for instance can generate finance by using two mechanisms. The first one is by issuing shares that are transferable called equity security. Secondly, companies may borrow money from the public by issuing an instrument called debenture which is called debt security.[8] In addition to these sources of capital, Share Company may borrow capital from individuals, banks, and other lending agencies and others. This calls the involvement of 3rd parties either legal or natural called creditor.

The term creditor can be defined as any third party who has a payable or in-the-future-to-become payable claim against a debtor.[9] As it can be clearly understood from the above definition, creditors are not only those voluntary third parties who have contractual dealing with debtor but also it includes persons who are to become creditors and against whom the debtor could become liable for tort and other reasons. This group of creditors is also known as an involuntary creditor as they have the status of being creditor only after the claim has arisen due to a certain occurrence.[10] Further, creditors may also have institutional or non-institutional character.[11] Their rights are also varying, ranging from secured bondholders to unsecured creditors. Further, in terms of their protection, creditors can be protected either through statutory mechanisms provided under company or insolvency law or on contractual bases also known as self-help mechanisms.[12]

In the corporate form of doing business where limited liability shields the company's owner from the creditor, the liability of the members is not any more beyond the promised contribution. In such a case, proceeding against the company by creditor would not beyond the asset of the

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[6]ErmiasAyalew and NegaMihretie, *Law of Traders and Business Organizations*, Bahir Dar University and Jimma University, 2010, p. 108 [hereinafter, Ermias and Nega, *Traders and Business Organization*]
[7]*Ibid*
[8]*id,* p. 107
[9] Elis Tarell, *Basel ii, and the protection of creditors in company law The Role of Banks as Financial Intermediaries in the Protection of Third Creditors of Debtor Companies*, Ph.D. Dissertation, Hamburg University,2015,[unpublished], p. 5[here in after Elis Tarell, *Basel ii and the protection of creditors in company law)*
[10]*Ibid*
[11]*Ibid*
[12]*Ibid*

company. Both statutory and self-help mechanisms on creditor protection seek to mitigate the effects of a "blind" or automatic application of the principle of non-personal liability of shareholders and directors. [13]

Creditor in a given company may represent dual roles. In the normal course of things, they are contractual counterpart of the firm, but if the firm is unable to meet its payment obligation, their position will be changed as being the owner of the firm and thereby entitled to seize and sell the company's asset.[14] In both these roles, creditors face different agency problems as a result of separation of ownership and control. As contractual counterparties, they face the possibility of opportunistic behavior by the firm acting in the interest of its shareholder.[15] Whereas at the time of insolvency, the creditor may conflict with other creditors to assure that one group of creditor is not expropriated by another.[16] So as to reduce these agency costs and in order to ensure a fair and balanced distribution of business risk among the parties involved in the relationship, every corporate law includes some provisions to protect creditor and in turn to lower the cost of raising debt finance.[17]

As has been stated earlier, creditor's protection can be sourced either from contract which is called self-help mechanism or from statutory regulation. Among the principal legal strategies that protect creditors, mandatory disclosure, rules governing legal capital, corporate groups, capital maintenance provision, and fiduciary duties are the prominent one employed by jurisdictions.[18] Protecting creditors through mandatory disclosure premised on the idea that those 3rd parties who lend or advance credit should benefited from having reliable financial information related to the company.[19] Accordingly, corporations are expected to publicly disclose

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[13] Peter O. Mü Albert, 'A Synthetic View of Different Concepts of Creditor Protection, or: A High- Level Framework for Corporate Creditor Protection', Volume null / Issue 01, *European Business Organization Law Review*, 2006 p.364, March, pp 357 – 408, Published online: 21 June 2006 available at:http://journals.cambridge.org/abstract_S1566752906003570, (hereinafter Peter O. Mü Albert, 'A Synthetic View of Different Concepts of Creditor Protection

[14]Supera note at 2, ReinierKraakman et al, *The Anatomy of Corporate Law, A comparative and Functional Approach*, p. 109

[15]*ibid*

[16]*ibid*

[17]*ibid*

[18]*id,* p.78

[19]Hanno Merkt, 'Creditor Protection through Mandatory Disclosure' *European Business Organization Law Review* vol.7: 95-122 95, *TMCSSER PRESS DOI*© 2006, p. 96[here in after Hanno Merkt, 'Creditor Protection through Mandatory Disclosure']

basic information at different times either before starting a business or after that by requiring a corporation to keep proper accounting and certified auditing and subsequent disclosure of accounts.[20] By capital maintaining rules, corporate creditors can be protected from improper distribute on of the company's asset to its shareholder before their claim has settled.[21] Further, this rule ensures the normal system of priorities which require that the creditors' claims on the company are satisfied in advance of those shareholders.[22] The protection of creditors has also become important in the vicinity of insolvency or in near of insolvency when the company faces financial distress as there is a great incentive for managers acting in the interest of shareholders to engage in value decreasing transaction.[23] Consistently, legal restrictions are placed on the companies so as to encourage managers of such distressed corporations to act as in the interest of creditors.[24]

Under the current Ethiopian legal framework, the protection of creditors has covered under different legislation governing both in financial and non-financial share companies. The 1960 commercial code as a principal legal document governing companies, lays down some rules on the protection of creditors in relation to mandatory disclosure, capital maintenance, and more importantly on the insolvency of the companies. However, these provisions are not adequate enough to safeguard the creditors' interest. Thus, the needs to analyze the Ethiopia share company law in providing effective protection for the corporate creditors motivate this researcher to undertake this study.

1.2. Statement of the Problem

A well-designed corporate law has the objective of striking a balance between the competing interest of shareholders and creditors.[25] However, the share company law has been criticized as being more shareholders friendly with the general objective of promoting investment. Having such basic character, the adequacy of Ethiopia share company law to provide effectiveprotection

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[20]*id*, p. 97
[21] Jonathan Richford, *Reforming Capital Report of the Interdisciplinary Group on Capital Maintenance*, The Company Law Centre, British Institute of International and Comparative Law, April 2004.p. 923[here in after Jonathan Richford, *Reforming Capital Report of the Interdisciplinary Group on Capital Maintenance*]
[22] *Ibid*
[23]Supera note 2, ReinierKraakman et al, Anatomy of Corporate Law, p. 114
[24]*Ibid*
[25]*id*, p. 197

for corporate creditors is questioned in the lenses of the modern corporate governance and company law principles.

The very important issue in designing a good corporate governance structure is building a capacity of creditors to protect their own interest for themselves by accessing full, accurate, and timely information about the financial situation of the companies.[26] If the corporate creditors are in a better position to access the company's basic information, they will be able to carry out the process of screening as well as the on-going debt contract in a very effective fashion.[27] But if there is a poor disclosure regime, it will pose a great danger to the effective functioning of the capital market and thereby the cost of capital will be raised. [28] To that effect, almost all company laws around the world including the OECD principles[29] explicitly recgenize that shareholder and other stakeholders including creditors should be given a high quality of disclosure of material information on the financial, operation, performance, ownership, and governance of the company.[30] Besides, the strength of the financial reporting standard on which the information is prepared and reported has also a strong implication on the quality of financial disclosure.[31] Accordingly, the OECD principle provides that information should be prepared and disclosed in accordance with the high quality of standard of accounting for financial and non-financial disclosure.[32] In addition to this, the annual audit should be conducted by independent, competent, and qualified auditors.[33]

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[26]Michael J. Mumford et al, 'Making Creditor Protection Effective', *The Centre for Business Performance Publisher*, London, 2010, p.2 [here in after Michael and Alen, 'Making Creditor Protection Effective']

[27]ReinierKraakman et al, Anatomy of Corporate Law, p. 197

[28]GebeyawSimachew, A *Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance*, dissertation, University of London, 2011-2012, (unpublished) available at: http://sasspace.sas.ac.uk/4733/1/Gebeyaw_Bekele_LLM_ICGFREL_dissertation.pdf. P. 19

[29] Principle 5 of the OECD states that, 'The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company'

[30]TewodrosMeheret, Governance of Share Company In Ethiopia.p.97

[31]*Ibid*

[32]OECD Principle, 2004, available https://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>(last accessed 16-oct-20) OECD Principle of Corporate Governance, principle 5 (here in after OECD principle

[33]*Id*, principle 5 (c)

However, whether the Ethiopia company law has adopted a corporate disclosure rules and regulation which provide an adequate guarantee to the creditors is questionable. so much so that, an investigation of the Ethiopia share company law needs to be scrutinized

Further, In the business venture where legal personality coupled with limited liability, it is the capital of the company that serves as the security of creditor's repayment. It is a modern company law principle that the capital of the company needs to kept intact as there is a contribution of creditors and should guarantees repayment to the creditors.[34] This principle further devolves into different rules focused on the payment of dividends and other distributions to shareholders, reduction of a company's share capital; financial assistance for the purchase of its own shares and redemption or purchase of its own shares, valuation of non-cash consideration and others.[35] Though the Ethiopia Commercial Code provides some of these rules which maintain the capital of the company, it lacks adequacy for the following specific problems.

a. To prevent overvaluation and the resultant exaggeration of capital, contribution in kind should be valued by independent experts other than shareholders themselves.[36]The correct valuation of property is one important mechanism to determine the real value of the capital. Though the Commercial Code of Ethiopia has provided the valuation of property by an independent expert appointed by the MOTI[37], the new Commercial Registration and Business Licensing Proclamation No. 980/2016[38]come up with a different stipulation by conferring the power of valuation of property made in kind to the shareholder themselves. However, whether the law has a mechanism to control overvaluation of in-kind contribution and other related valuation problem is questionable. Thus, a critical study of this proclamation is necessary in determining the existence of proper valuation on in-kind contributions.

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[34] Md. Saidul Islam, 'The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis', *Volume IV (2013) ISSN 2218-2578*, *The Northern University Journal of Law,2013.* p.47[here in after Md. Saidul Islam, 'The Doctrine of Capital Maintenance (.this rule is originated to the UK)

[35] *Id*, p. 59

[36] TilahunTeshome, AmanAssefa, et al, *A Position of the Business Community on the Revision of the Commercial Code of Ethiopia*, Addis Ababa Chamber of Commerce and Sectorial Associations, Addis Ababa,2008, p. 21[here in after TilahunTeshome, AmanAssefa, et. al, A Position of the Business Community]

[37] Com. Code, Article315

[38] Commercial Registration and Business Licensing Proclamation, 2008, *Federal NegaritGazeta*, Proc no 980/2016, 22nd year, No. [here in after, Proc. No. 980/2016

b. Among different restrictions made on distribution, the most common one across jurisdictions is the restriction of payment of dividends which impairs the company's legal capital.[39] To that effect, corporate law provides several restrictions that limit the manner of distributions. Among those restrictions the one is, it is only from the net profit that the company can distribute the dividend. If not, the distribution of dividends will be regarded as a fictitious dividend. Consequently, the dividend paid not from net profit and distributed to shareholders is usually claimed back from shareholders who received the dividend knowing violation of law. This is being the case, whether the Ethiopia company law has a dividend policy which taken into account the interest of creditors and maintain thecapital of the company begs a question. Therefore, the provisions of the commercial code need to be scrutinized in relation to dividend distribution rules.

c. Among different activities of the company which reduces the value of the capital, cross-holding is the one. The result of this joint holding is the stated amount of capital of each company in which creditor relay may be regarded as partly fictional.[40]In this kind of situation, the interest of the creditor may be at stake as a certain amount of capital is controlled by more than one company and each member of the company has their own separate legal personality with limited liability (which one company will not be liable for the debt of another). Given this and other complex issues, it is desirable to have a company law which governs the aspect of corporate group in general and joint holding in particular as the use of corporate group proliferate from time to time. This being the reality, whether the Ethiopia company law has sufficiently incorporated rules which govern joint holding is questionable. Therefore, it is imperative to scrutinize the provision of commercial code with the view to address the interest of the corporate creditor.

d. For effective protection of corporate creditors, in addition to that of the provision of capital maintenance, company law of different country includes provisions which control the opportunistic actsof directors of the share company in the vicinity of insolvency. Whether or not the Ethiopia share company law includes those rules will be the question of this paper.

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[39]ReinierKraakman, Anatomy of Corporate Law, p. 131
[40]*Ibid*

1.3. Objectives of the study

1.3.1. General Objective

- ❖ The general objective of this study is to critically analyze the legal framework on the protection of creditors under Ethiopian share company law and to evaluate its adequacyin light of international recommendations.

1.3.2. Specific objectives

- ❖ To deeply examine the creditor's protection under Ethiopia commercial code including other relevant legislations.
- ❖ To analyze problems related to corporate disclosure of material information for the purposes of corporatecreditor protection.
- ❖ To evaluate the adequacy of the Commercial Code of Ethiopia in relation to capital maintenance provisions.
- ❖ To examine the problems of Commercial Code on the rule of dividend distribution.
- ❖ To evaluate mechanisms adopted by the Commercial Registration and Business Licensing Proclamation No. 980/2016 with regard to valuation of in kind contribution.
- ❖ To scrutinize whether the Ethiopia company law adequately addressed the issue of joint holding.
- ❖ To examine whether the law adequately address the protection of creditors in the near of company's insolvency.

1.4. Research Questions

1.4.1. Central Research Question

The main research question of this study is

- ❖ Does the Ethiopian share company law provide adequate protection for creditors?

1.4.2. Sub central research question

- ❖ How the Ethiopian share company law ensures the disclosure and transparency of material information so as to provide adequate protection for creditors?

- ❖ Do the capital maintenance rules adopted by the law provide adequate protection for creditors?
- ❖ Does the rule on distribution of dividends under Ethiopia share company law take into account the interest of creditors?
- ❖ Is the mechanism adopted by Proc. No. 980/2016 for in kind contribution affects the protection of creditors?
- ❖ How far the Ethiopia commercial code regulates the issue of joint holding?
- ❖ Does the Ethiopia share company law provide those rules that protect the creditors in the near of company's insolvency.

1.5. The significance of the study

As this study mainly focuses on the creditors' protection under Ethiopian share company law, the researcher has a strong belief that the study will contribute something valuable on this area which has limited existing knowledge. So that, it will serve as an important input for academician who pursues a further study on the area. Besides, the study will also serve as an academic reference material. In addition to this, it will have also the following practical relevance like:

- o The study will serve as an input for legislator and policymaker, to revisit the existing laws on creditor protection.
- o The study will also have a significant contribution to create and to increase awareness for the legislative body, corporate creditors, lawyers, and other stakeholders.

1.6. Literature Review

In the international arena, the issue of creditors is a subject matter of numerous literature and empirical studies. As the researcher inquiry reveals, there is no full-fledged study conducted on the issue of creditor protection in Ethiopia. Hence, the issue of creditor protection is not given much attention in the domestic literature. Even the few works of literature that are somehow related are more focused on the general aspect of corporate governance issues.

To mention some, TewodrosMehret has written an article.[41] In his article, he highlighted the OECD principles with regard to disclosure and transparency obligation of the board. And he only questioned how the Ethiopia commercial code ensures disclosure and transparency so as to protect the right of creditor. Further, another writer called GebyawSimachew[42]generally asserts the need to revise the existing commercial code with the advent of the OECD principles in addressing the interest of stakeholders. On almost a similar issue, another writer called Hussein Ahmed Tura[43] has tried to discuss how the creditor and investor face difficulties due to lack of transparency and disclosure. Besides, EndalewLijalem has also written an article.[44] In his article, he discussed the legal, judicial recognition, and the different grounds to pierce the corporate veil. Further, FekaduPetros in his book titled *the Ethiopian Company Law (*Amharic Book*)*, tried to pinpoint the general issue of disclosure and transparency and the capital maintenance provisions. All in all, none of the above-cited writers and others addresses the issue of creditor protection in adequate manner. Accordingly, this researcher believes that conducting this research will be different in terms of its content and in undertaking a depth analysis of creditor protection under the company law of Ethiopia.

1.7. Methodology of the Study

1.7.1. Research Type and Approach

The researcher employs a qualitative research method. The main purpose of this study is to critically examine the legal framework for the protection of creditors under Ethiopian share company law. Accordingly, a qualitative method of research is suitable in order to accomplish the research objectives specified and to properly address those basic questions that are framed above. Besides, the qualitative method is the best research tool for depth understanding of the problem with a high degree of flexibility. In addition to this, as the very objectives of this research is to critically analyze the existing share company law on creditor's protection in light of

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[41]Supera note 2, TewodrosMeheret, Governance of Share Company in Ethiopia, p. 97

[42]Supera note 27, GebeyawSimachew, A *Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance,* p.31

[43]Hussein Ahmed Tura, *reforming corporate governance in Ethiopia: appraisal of competing approaches,*Oromia Law Journal Vol. 3 2014, Ambo University,p. 189 (Hussein Ahmed, Reforming Corporate Governance in Ethiopia)

[44]EndalewLijalem, 'The Doctrine of Piercing the Corporate Veil: Its Legal and Judicial Recognition In Ethiopia, *Mizan law review,* Vol. 6 No.1, June 2012, PP. (78 -114),p. 98 [herein after EndalewLijalem, The Doctrine of Piercing the Corporate Veil In Ethiopia]

international recommendations, the modern company law principles including the OECD principles on corporate governance and the doctrine of capital maintenance is consulted in evaluating the adequacy of creditor protection. The reason why these principles have opted is the OECD Principles of Corporate governance is now a day serve as an international benchmark for policymakers, corporations, and other stakeholders worldwide and has universal acceptance.

In addition to that, this research adopts the doctrinal research type because of its suitability for analysing legal rules and principles and it also helps to appreciate the existing legal loopholes regarding the subject matter of this study.

1.7.2. Types of Data and Data Collection Tools

To undertake this research, both primary and secondary data are used.Since the study is a doctrinal type of research, it bases itself on the analysis and examination of different legislations. Accordingly, the researcher examined the relevant Ethiopian company law including Commercial Code, Business Licensing and Registration ProclamationNo. 980/2016, Financial Reporting Proclamation No. 847/2014 and other relevant legal instruments as a primary data. This analysis of laws helped to address the six specific research objectives and the first five questions of the study. Further, the researcher conducted an interview as a primary data collection tool. Among different types of interviews, the semi-structured type is selected to conduct in depth interview with the concerned focal persons like elites, who have a good knowledge about the company law of Ethiopia, an official from trade and industry, to analyze the effect of the proclamation no. 980 /2016 on non-cash consideration and the disclosure right of corporate creditors and auditing and accounting board of Ethiopia (AABE) to examine the disclosure rights of creditors. Among different types of interviews, the semi-structured type is selected due to its flexibility and suitability to have a predetermined set of questions with additional clarification in case when the question is not clear for respondents. Secondary data like documents including books, journal articles, research works, soft laws, unpublished materials, reports, newspapers and internet sources were put in use.

1.7.3. Sampling Techniques

In order to choose the participants, purposive sampling is selected owing to the participant's position, experience, expertise, educational background, and other important factors that would

help to acquire important data. As far as its size is concerned, the researcher conducted the interview until the criterion of redundancy is met.

1.7.4. Method of Data Analysis

As the study adopts a qualitative method of research, the qualitative method of data analysis is used. Accordingly, first, the researcher has collected and prepared the relevant data through the data collection method explained earlier. Second, the data is categorized into meaning full way. Third, the data is interpreted with a view to identifying the important points, and finally, a conclusion has been drawn from such interpretation.

1.8. Scope of the Study

This study is limited to analyse the legal framework on creditor's protection under the Ethiopian share company and its adequacy. Further, as the protection of creditors encompasses two types of creditors such as voluntary and involuntary, the issue of creditor protection is important in both types. While voluntary creditors are those who agreed to lend a certain amount of money or asset to the company, involuntary creditors assumed this position as a result of certain occasion such as tort, insolvency or default of tax. This research did not address the issues with regard to involuntary creditors and their protection for the purpose of specificity. Besides, the financial share companies are also excluded from this study since these financial institutions such as banks, insurance companies and micro finance institutions are subject to a more sophisticated legal regime as compared with the commercial code of Ethiopia and are subject to a strict financial regulatory system.

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1.9. Limitation of the Study

The major limitations that the researcher faced in undertaking this study was, lack of reference material as there is no domestically written materials on the subject matter of corporate creditor protection. Time constraint, as the researcher was delivered a baby in the last year, writing the paper with the responsibility of taking care of the baby was a difficult task. Most importantly, COVID 19 was also an obstacle for the study since it was difficult to visit some government offices and collect important information.

1.10. Ethical consideration

In undertaking this research, the researcher employed these three important ethical considerations. The first one is consent. Before the participants take part in this study, first, the researcher promptly secured their consent. Secondly, any data or information collected from them is kept confidential. And the researcher also respected their anonymity unless they consented to reveal their identity. Finally, the researcher duly acknowledges their invaluable contribution to the research.

1.11. Organization of the paper

The study has five chapters. In the first chapter, the paper addresses the introduction of the study. It specifically includes the background of the study, statement of the problem, objective of the study, research question, and methodology of the study, method of data collection, significance of the study, limitation of the study, ethical consideration. The second chapter of the paper reviewed important literature on creditor's protection. It specifically dealt with, but is not limited to, the definition of the creditors, types of creditor, and the rationale behind for corporate creditor protection. The third chapter of the research is devoted to critically analyse those mechanisms of creditor protection in general. The fourth chapter analysed the major rights of corporate creditors under Ethiopian share company law and the inadequacies of the law in protecting creditors has also addressed. In assessing the legal protection conferred to corporate creditors, the OECD principle on corporate governance and the doctrine of capital maintenance has been used as a parameter. It specifically addresses the legal regimes on the protection of creditors. In addition, the inadequacy of the Ethiopian share company law on creditor's protection is analysed. This part specifically addresses the protection of creditor with regard to corporate disclosure, capital maintenance rules in relation to the distribution of dividends, valuation of property, and joint or cross-holding. The final and the fifth chapter devoted to the conclusion and recommendation drawn from the study.

CHAPTER TWO: GENERAL OVERVIEW OF CORPORATE CREDITORS' PROTECTION

2.1. Introduction

This chapter discusses the corporate creditor's protection in general. Specifically, the chapter first deals about the definition of the term creditor and then present the justification for corporate creditor protection. Besides, the types of corporate creditors are also discussed.

2.2. The concept of corporate creditor

The term creditor has given a different meaning in a variety of literatures. Despite such differences, it is pivotal to have a clear understanding of the term. Broadly defined, the term creditor can be understood as a "country, organization, or person to whom money is owed."[45] As it is possible to grasp from this definition, creditors may include a broad spectrum of groups to include not only a person but also a country. At this juncture, it is good to underline the fact that who is creditor will often depend on the circumstances in which one is asking a question.[46] Accordingly, this term might be given a specialist meaning in appropriate circumstances especially in legislation. Hence, the UNCITRAL legislative guide on insolvency law defines the term creditors as:

"Creditor is a natural or legal person that has a claim against the debtor that arose on or before the commencement of the insolvency proceedings."[47] This definition has further explained the term by making clear that the creditor as a person could be legal or natural. Besides, it also further indicates that a creditor is a person who has a claim. Claim in this particular guide is understood as a right to payment from the debtor's estate which may arise from debt, contract, or other types of legal obligation.[48] In this explanation, the creditor's claim may take different forms, i.e. it may be liquidated or unliquidated, matured or unmatured, secured or unsecured,

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[45] *The* Cambridge Advanced Learner's Dictionary & Thesaurus © Cambridge University Press), 1995, s.v. 'Creditors'

[46] Andrew Keay, *Company Directors' Responsibility to Creditors*, Taylor &Francis group, an Informal Business, UK,1st edition, 2007, p. 14(hereinafter Andrew Keay, *Company Directors' Responsibility to Creditors*)

[47] UNICETRAL Legislative Guide on Insolvency Law, United Nation, New York, 2015, p. 3 [here in after UNICETRAL Legislative Guide on Insolvency Law]

[48] *Ibid*

fixed or contingent. [49] This definition can be regarded as comprehensive as it tries to dot down the types of person that could have the status of creditors, i.e. legal or natural. It also further states that this person to be regarded as the creditor, it needs to have a specific claim sourced from contract or legal obligation. More interestingly, it also comes up with the different types of claims.

Black's law dictionary defines the term "creditor" as [50]

1. One to whom a debt is owed; one who gives credit for money or goods. — Also termed debtee.
2. A person or entity with a definite claim against another, especially a claim that is capable of adjustment and liquidation.

According to this definition, creditors are simply those persons who have a claim against the debtor. Moreover, it tries to shed alight for what the debt is given i.e. either for money or good. But it doesnot tell the very source where the claim originated. Elis Tarelli in his dissertation defines the term creditors as "any third party who has a payable or in the future to become payable claim against a debtor".[51] According to this definition, creditors are not only those third parties who knowingly and willingly are in contractual relation with the debtors but it also encompasses other persons who become creditors after the claim has risen due to a certain occurrence.[52] This definition differentiates the types of creditor who has a claim against the debtor in to voluntary and involuntary. Not only this, it also indicates the status of the creditor as being 3rd party (outsider) to the company.But one can say that this definition is not still complete as it failed to indicate the nature of the claim that the creditors might have and where it might be sourced. In any credit relationship, there is a list of two parties such as creditor and debtor. Due to that, understanding the term creditor without its counterpart (the debtor) may create an incomplete picture. Accordingly, a debtor is the one who owes a debt or the performance of an obligation to the creditor or the one who may be compelled to pay a claim or demand. [53]

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[49] *Ibid*

[50] *Black's Law Dictionary*, 8th ed., *s. v* ‘’ creditor’’

[51] *Supranote* 9, Elis Tarell, *Basel ii and the Protection of Creditors in Company Law,* p.17

[52] *ibid*

[53] The free dictionary by Farlex, available at https://www.thefreedictionary.com/Videthe free dictionary.com/debtor. Last accessed on May 19, 2020 available at. Last accessed on May 19, 2020

Generally speaking, from the above definitions, one can understand these common elements. Firstly, creditors are a person either legal or natural. This legal person could be an organization, company, government, and so on. The existence of a certain claim against a debtor is also the other common elements that can be grasped in these definitions.

Under Ethiopian law governing Companies, there is no definition given for the term creditor. Having said this, as this paper's basic concern is creditor protection it will be plausible to have clear insight about what is meant by creditor protection. Accordingly, creditor protection is understood as mechanisms the aim of which is to protect the interest of a person designated as a creditor. Such protection of creditors may be embodied in statutory protection for creditors in company law rules on lifting the veil of the company, rules which can extend liabilities to individuals standing behind the veneer of the company or through contractual means called self-help mechanisms.[54] As the very business of this paper is limited to companies or corporate creditors, its focus will be thus on those creditors of non-financial companies and the legal protection accorded to them under Ethiopian share company law. Accordingly, the creditors of non-financial limited liability Share Companies will be the center of this study.

2.3. Justification for Corporate Creditor Protection

The primary justification for the protection of corporate creditors has rooted in the nature of the corporate entities itself. As it is well explained in a variety of literature on the nature of the company, limited liability and legal personality are among the basic characteristics of a company that attracts investments. As an entity bestowed with legal personality, a company is a legal person separate and distinct from its member who constitute it. Having Legal personality involves the demarcations of asset that is distinct from other asset owned by the firm's owner.[55] Not only this, once the company is conferred with a separate judicial personality, it will be automatically able to hold liability in its name. [56] As a result of this, at the time when the company incurs any debt, the creditor can enforce their claims against the assets of the company

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[54]Mr Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring*, Ph.D. dissertation, University of Glasgow, 2008, p. 159, (hereinafterMr Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring*)

[55]Supera note 2 ReinierKraakman et al, *The Anatomy of Corporate Law*, p. 6

[56] Maria Elena PericiCalasciounine, *Fraudulent and Wrongful Trading – Case Study of A Judicial Appreciation*, Master's Thesis International Business Law, Van Tilburg University, unpublished available July 2012, p. 6(hereinafter Maria Elena, *Fraudulent and wrongful trading – case study of a judicial appreciation*)

not against the personal assets of shareholders. [57] More importantly, legal personality grant creditors of the firm with priority rule which provides that the claims of the creditors of the firm have got precedence over that of the claims of its owners and their creditors. [58] Consequently, the firm's assets are made available for the enforcement of contractual liabilities entered into on the name of the company.[59] The other basic principle as well as characteristic of a company is the existence of limited liability. According to this principle, the liability of the member of the company is restricted[60] to the amount paid (and/or unpaid, if under a certain jurisdiction's laws such payment can be deferred in time) on shares. [61]Consequently, limited liability is a rule that protects the assets of the firm's owners from the firm's creditors whereby creditors are limited to make claims against the asset that is owned in the names of the company itself, and thereby the owners of the company are no more liable beyond the contribution they have made to the company. [62] This principle is regarded as being the universal feature of corporate form provided by the most advanced corporate legislations.[63]Our commercial Code indicates these basic features of the corporate business venture under art 304(2) by limiting the liability of the shareholder to extent of their shareholding.

As a corporate form of business venture provides such default rule of limited liability in its contract between the company and its creditors [64]when a corporate borrower is provided with a certain amount of money, a creditor must necessarily undertake the risk of dealing with such limited liability of the company.[65] To that effect, any framework sought for the protection of corporate creditors has to incorporate the principle of limited liability (non-liability of

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[57] Maria Elena, *Fraudulent and wrongful trading case study of a judicial appreciation.* In the UK, the principle of separate juridical personality was established by the House of Lords in *Salomon v A. Salomon & Co. Ltd*5 and has subsequently been referred to as the 'Salomon principle'.

[58]Supera note 2, ReinierKraakman et al, *The anatomy of corporate law*, p. 6

[59]*ibid*

[60] The limited nature of liability is only for the firm's owners not for the firm itself as it is unlimitedly liable with all its assets as long as it incurs the debt.

[61] Maria Elena, *Fraudulent and wrongful trading – case study of a judicial appreciation, p.6*

[62]Supra note 2, ReinierKraakman et al, *The Anatomy of Corporate Law*, p. 8

[63]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 18

[64]ReinierKraakman et al, *The anatomy of corporate law*, p. 8

[65]Natalia Andreicheva, *The Role of Legal Capital Rules in Creditor Protection: Contrasting the Demands of Western Market Economies With Ukraine's Transitional Economy*, LLM thesis, [Law Department of the London School of Economics and Political Science for the degree of Master of Philosophy, January 2009, P. 13[here in after Natalia Andreicheva, The role of legal capital rules in creditor protection]

shareholders) for corporate debts as an additional problem.[66] This is because the application of the limited liability in corporate form is not without risk as it paves the way for the company to act opportunistically towards its creditors. [67]As the risk of shareholder is not beyond their investment, they might use the privilege of limited liability as a means of expropriating third party creditors and extracting unlawful benefits.[68] Moreover, the existence of limited liability gives shareholders an incentive to engage in actions that benefit themselves at the expense of creditors.

In response to those risks brought by limited liability, legislatures have attempted to provide some degree of protection for creditors to reduce the likelihood of companies not paying their debt and thereby protecting corporate creditors.[69] It is for this primary justification that every corporate law includes some rules protecting corporate creditors to mitigate the blind effect of the principle of limited liability.[70] In a net shell, counterbalancing the limited liability and separate personality of a company is the general safeguard of the protection of creditors.

Apart from the nature of the company which demands protection of creditor, creditor's protection can be justified by making available cheap credit in the capital market. According to the view of many economists and legal experts, creditor protection is crucial for the development and optimal performance of the credit market.[71] This is because, if the credit market performs well, it can provide cheap funds which in the end encourage entrepreneurship.[72] In the nutshell, the

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[66] Peter O. Mülbert, 'A Synthetic View of Different Concepts of Creditor Protection, or: A High- Level Framework for Corporate Creditor Protection', Volume null / Issue 01, *European Business Organization Law Review*, 2006 p.364, March, pp 357 – 408, Published online: 21 June 2006 available at: http://journals.cambridge.org/abstract_S1566752906003570, (hereinafter Peter O. Mülbert, 'A Synthetic View of Different Concepts of Creditor Protection)]

[67]Christopher J. Cowton, 'Putting Creditors in Their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability', *University of Hudders Field Business SchoolQueens gate*, United Kingdom, p, 25 (hereinafter Christopher J. Cowton, 'Putting Creditors in Their Rightful Place)Coiton p, 25

[68] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 25

[69]Christopher J. Cowton, 'Putting Creditors in Their Rightful Place p, 25

[70] Peter O. Mülbert, 'A Synthetic View of Different Concepts of Creditor Protection, p. 367

[71]Atilano Jorge Padilla and Alejandro Requejo, 'The Costs and Benefits of the Strict Protection of Creditor Rights: Theory and Evidence',*Inter-American Development Bank Working Paper No.114*, New York Avenue, N.W. Washington, D.C., May 2000, p.1 (hereinafter Atilano Jorge Padilla and Alejandro Requejo, 'the Costs and Benefits of the Strict Protection of Creditor Rights),

[72]*Ibid*

availability of cheap credit is mainly depending on the level of creditor's protection and sanctions on non-performing debtors are enforced.[73]

2.4. Types of corporate creditors

Knowing the category of corporate creditors is vital in identifying their risks and in providing a corresponding protection.[74] Corporate creditors can be classified into different groups depending on different parameters. Under this section of the paper, an attempt will be made to discuss each category of creditor.

2.4.1. Secured versus Unsecured Creditors

Depending on whether a creditor has a claim which is backed by real assets or not, creditors can be classified into secured and unsecured creditor. Starting from the first one, a secured creditor is a creditor who has the right to satisfy their claim by tracing collaterals when the debtors fail to pay his debt either the company fails to meet its repayment schedule or the company enters some form of insolvency regime such as liquidation.[75] Besides, such creditor of the company is granted proprietary right over a company's asset enabling them to exert some action over the asset if necessary.[76] In the hierarchy of claims that should be satisfied upon debtors default, secured creditor claims will be ranked higher than any other claims including the corporate owners or the company itself. [77] Accordingly, a secured creditor in addition to his creditor's claim has collateral in the form of mortgage, pledge, or other security interest in a particular asset of the debtor company. Hence, the creditor will monitor the company and the asset over which their claim is secured. This place secured creditor on preferential position over other creditors in a case when the debtor company faces financial difficulty. In Ethiopia, secured creditors are generally governed by the law of security devices based on special contract such as guarantee,

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[73] *Ibid*
[74] Supra note 66, Peter O. Mülbert, A Synthetic View of Different Concepts of Creditor Protection, p. 366
[75] Andrew Keay, *Company Directors' Responsibility to Creditors, p.15*
[76] *ibid*
[77] Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 31

pledge, mortgage and others but the general principle and guideline from the provision of general contract is still applicable. [78]

Unsecured creditor on the other hand is a creditor who, upon giving credit, takes no rights against specific property of the debtor company. [79] As a result of this, they have to rely primarily on their contracts with the debtor for their protection. [80] This category of creditor is also termed as general creditors. Hierarchically, unsecured creditor's claims to the assets of the debtor company ranks lower than that of secured creditors but higher than the debtor company.[81] Hence, this general creditor is residual claimants as compared with secured creditor as a matter of principle, when the company enters into liquidation unsecured creditors are treated equally when it comes to paying them out.[82] This is a principle called *paripassu*.[83]Under this broad category of the creditor, there are various types of creditor ranging from money lender such as debenture holder to trade creditor who supply goods and services, a consumer who has paid a deposit to a company in exchange for the promise of delivery of goods and services, tax authority, the employees of companies and involuntary creditor. [84]

At this juncture, it is good to underline that both secured and unsecured creditors may face the general agency problem when dealing with the debtor company. Accordingly, the mere existence of the collateral does not necessarily eliminate the risk of default and opportunism. However, as compared with unsecured creditors, secured creditors are in a better position to be protected from the debater's misbehavior.[85]

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[78]AddisuDamtie&Mizanie Abate,*Law of Sales Module and security device*, Bahir Dar University Distance Education, 2010, p.112 (here in after AddisuDamtie&Mizanie Abate*, Law of Sales Module and security device*).

[79] Black's law dictionary, s.v "unsecured creditor"

[80]*Supranote*46, Andrew Keay, *company's director responsibility to creditor, p. 15 and 16.* This group of creditor has no assets of the company to secure their claim unless they supplied goods subject to contracts which contain what are known as 'retention of the title clause

[81]*Supranote* 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p.31

[82] Andrew Keay, *company's director responsibility to creditor, p. 16*

[83]*Ibid*, But exceptionally some type of creditor like revenue authority, employees, retention of title creditors are treated as preferential creditors who can get precedence over other types of involuntary creditors.

[84]*Supranote* , 80, Andrew Keay, *Company's Director Responsibility to Creditor, p. 15*

[85]*Supranote* 9, Elis Tarell, *Basel ii and the protection of creditors in company la, p.*32

2.4.2. Voluntary versus Involuntary Creditor

Corporate creditors can be classified as voluntary and involuntary based on whether the creditor willingly entered into a credit relationship with the debtor or whether this contract was imposed by circumstances he neither chose nor could control.[86] Starting from the first one, a voluntary creditor is an incumbent creditor who knowingly and willingly enters into a credit relationship with the debtor.[87] In this case, the corporate creditor decided to enter a contract with the corporate debtor of his free will. An example of this type of creditor including but not limited to banks who agree to provide loan to the company, an employee who has worked for a month but is not paid until the end of the month, and trade creditor who has not been paid for the good which they deliver. [88] Due to the voluntary nature of the contract, voluntary creditors are placed in a better position to distribute credit risk. This is because they enter into this relationship freely and can therefore optimally contract the amount and the type of risk they are willing to bear.[89] Involuntary creditor on the other hand is a third party who did not choose nor could have chosen to accept a claim against a debtor. [90] For this type of third party to have the status of creditor, there has to be a certain occurrence of events. This group of creditors covers those who have not agreed to become creditors because of some action or inaction of the debtor.[91]In sum, involuntary type of creditors also known as non- adjusting creditors it refers those parties for whatever reason are owed money by a corporate entity but are unable adjust the terms of their exposure to reflect therisk that they bear. [92] Tort victims, environment agency, and tax authorities(in right of regulatory claims) are typical examples of this group of creditors. [93]

As a creditor who can't adjust the terms on which credit is extended, shareholders might benefit at the expense of non-voluntary creditors by externalizing the costs of their activities and by

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[86]*id*, p. 34
[87]*id*, p. 5
[88] David Kershaw, *company law in context text and materials*, 2[n] ed. Oxford University Press,2006, p. 771(hereinafter David Kershaw, company law in context, text and materials)
[89] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 34
[90]*ibid* p. 5
[91]*Supranote* 80, Andrew Keay, *company's director responsibility to creditor, p. 18*
[92]*Supranote* 2 , Reinierkraaman*et al*, Anatomy Of Corporate Law, 115
[93]*ibid*

internalizing their benefits.[94] Consequently, they cannot preemptively protect themselves by taking into account the risk they involve. This inability to protect once own right is emanated from a lack of information. This is to mean: for instance, if one can see tort creditors, they do not know they will be injured, environmental creditors do not have full information about the conditions on private property, and taxing authorities rely on debtors company to provide information and may only obtain the right to question that information years after liability has been created.[95] Besides, such information asymmetry coupled with the principle of limited liability and separate legal personality make the position of this involuntary creditor more vulnerable. To mitigate these problems, literature has suggested that especially the tort involuntary creditors need special protection for instance by giving priority over voluntary creditors in an insolvency proceeding, by purchasing liability insurance, and by making shareholders liable for the excess of liability in case which shareholder control risky activities directly. [96]

In terms of risks that the involuntary creditor may encounter, it is much the same with that of their counterpart i.e. voluntary creditors.[97] These two types of creditors face the same risk concerning the opportunistic behavior of shareholders and the directors such as devolution of their claims against the company as a result of the company's inability to pay due to insolvency. [98] This risk may include the net present value of claims that may be less than their nominal value already at the time of coming into existence. Further, such claims may suffer from a subsequent devaluation. In sum, classifying creditors into voluntary and involuntary has an important implication over the types of protection available for them either through mandatory protection rules or self-help mechanisms. [99]

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[94] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 37

[95]Stephanie Ben-Ishai*et al* , Involuntary Creditors and Corporate Bankruptcy, *All Papers Research Papers, Working Papers, Conference Papers Law School of York University*, 2011, p. 257(here in after Ben-Ishai, , *et al.* "Involuntary Creditors and Corporate Bankruptcy)

[96]ReinierKraakma*et al*, The Anatomy of Corporate Law, 2004 ed, p. 77

[97]*Supranote* 13. Peter O. Mülbert, synthetic view of different Concepts of Creditor Protection, p. 370

[98]*Supranote*9, Elis Tarell, *Basel ii and the protection of creditors in company*, P. 34 for instance, involuntary creditors can not avail themselves for self-help mechanism as they are not in a position to deal with the debtor company.

[99]*ibid*

2.4.3. Strong versus weak voluntary creditors (adjusting versus non-adjusting)

Voluntary creditors can be further classified into strong and weak creditors based on their position in dealing with a corporate creditor. Starting from the strong type of voluntary creditors, it refers to those creditors who have the ability and of course the position to negotiate terms of the credit contract on which credit is extended to the corporate debtor.[100] Accordingly, these creditors are in a better position to monitor the activity of the debtor company to ensure compliance and also bear the respective monitoring costs. A typical example of this type of creditor includes financial creditors such as banks, bondholder also known as sophisticated creditors as they have this bargaining power to negotiate credit terms. [101] This group of creditors can also be called as adjusting creditors as they can voluntarily advancing a sufficiently large sum of money to be willing to incur the transaction costs gathering information, negotiation, and the like necessary to adjust the terms upon which credit is extended.[102] At this juncture, it is good to know that adjusting creditors are always voluntary creditors but not all voluntary creditors are necessary for adjusting creditors whereas involuntary creditors are necessarily non-adjusting creditors. [103]

Weak voluntary creditors are also known as non-adjusting creditors who lack bargaining power to safeguard their interest by way of debt covenant, security, and other instruments. [104] One can mention for instance trade creditors such as suppliers, and employees as a typical example of weak voluntary creditors. Employees are considered as being a weak creditor since they lack bargaining power compared to other creditors and investors. [105] Since, employees when negotiating the terms of their employment contract, they do not usually insist upon a provision to protect them should the employer become insolvent. [106]

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[100]*id*, p. 35
[101]*Ibid*
[102]John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', *The Modern Law Review*, Vol. 63, No. 3 (May, 2000) (here in after John Armour, 'Share Capital and Creditor Protection) p. 4
[103]Supra note 87, David, company law in context, p. 772
[104] Elis Tarell, Basel *ii and the protection of creditors in company*, p. 35 see alsoFerran, European Company and Financial Law Review, 2006, 178, p. 10
[105]Supra note 46, Andrew Keay, *Company's Director Responsibility to Creditor, p. 18*
[106]*Ibid*

Though both strong and weak creditors face the same risk of payment default, the mechanism they employ to protect themselves is different and this difference could also lead to a conflict of interest among the two.[107] This is especially true when the debtor company starts to experience financial distress; the strong creditor by using their contract will make the satisfaction of their claim even if their action could results in a cash flow crisis leading to insolvency.[108] But one thing that needs to be noted here is that restriction and monitoring activities with terms of covenant held by the strong creditors might have important implications for the overall benefits of the company's creditors including the weak one.

2.4.4. Short versus long term creditors

Depending on the period of their relationship with the corporate debtor, creditors can be classified into long term or short-termcreditors. Short term creditor as its name signifies it is a creditor that provide corporate debtor with a revolving line of short-term credit. [109] Banks, other institutional lenders, and small trader creditors including trade creditors, also have very short time-horizons and typical examples of short-term creditors.[110] Among this, small trade creditors are those who provide a small amount of credit to the corporate debtor. Due to their small contribution to corporate debt, they are not able to contract for collateral. [111] Banks on the other hand are secured creditors who might be able to exercise a certain degree of pre-contractual monitoring and by asking a disclosure of full information. Whereas long term creditors are creditors who have especially holder of bonds, debenture and employees of holding retirement deferred claims. [112] The situation of this long-term creditor's appears to be the same as that of sophisticated voluntary creditors. Accordingly, they are in a better position to put restrictions on the debtor company's distribution of its asset. [113] Due to that reason, these long-term creditors are better protected than that of the unsecured short-term creditors. What is dangerous for long- term

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[107] Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company*, p. 35
[108]*ibid*
[109]*id*, p.39
[110]*ibid*
[111]*ibid*
[112]*ibid*
[113]*Id*, p. 40

creditor is the risk profile of the company may be subject to alteration unfavorably after they have made advance and priced the loan. [114]

Both short- and long-term creditor is categorized under voluntary type creditor as they are aware of how long and for what amount that the credit relationship is created. Further, they are also expend resources such as time and effort to ensure the pre- and post-contractual monitoring of the debtor misbehavior.[115] Further, these two types of creditors are also similar in facing the same risk i.e. they both face the risk of payment default either because of normal business misfortunate or because of shareholders opportunistic behavior resulting in creditor expropriation. [116]

[114] Paul L. Davies, 'Directors' Creditor regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency'*European Business Organization Law Review,* February 2007, University of Oxford, p. 4 (hereinafter. Davies, Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency')
[115] Elis Tarell, *Basel ii and the Protection Of Creditors In Company*, p. 39
[116]*id*, p. 39

CHAPTER THREE: MECHANISMS OF CORPORATE CREDITORS PROTECTION

3.1. Introduction

In granting credit to companies, creditors can avail themselves of several protection measures to ensure the satisfaction of their claim. Concerning the relevant criteria for efficient creditor protection, the literature suggests that it is from those risks that a fully informed rational creditor would not accept voluntary that the creditor needs to be protected at the time of contract other than a simple business misfortune.[117] Depending on the prevailing legal tradition, creditors protection is usually provided either through statutory legal provision incorporated in the company, insolvency, and other laws or through contract or also known as self-help mechanism which aimed at allowing creditors to contract with a debtor company for the level of protection they think necessary. [118] Accordingly, the creditor's protection in the common law legal system is mainly provided by the contract. For instance, if one can see the experience of the US, the basic objective of their company law is to provide maximum flexibility for private regulation through contract.[119] The fundamental purpose of this company law under this tradition is the maximization of shareholders value. Whereas in the civil law legal tradition, it is through statutory provisions that creditors are usually protected. In civil law countries such as in Europe, the company law has fundamental purposes for the protection of creditors. [120]

Under this section of the paper, an attempt is made to scrutinize both these types of creditors protection mechanisms. However, as the paper is mainly concerned with the protection of creditors in company law, a detailed discussion will be made on it.

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[117]*Supranote* 13, Peter O. Mülbert, 'A Synthetic View of Different Concepts of Creditor Protection, p. 371
[118]*Supranote* 9, Elis Tarell, *Basel ii and the Protection of Creditors In Company Law*, p. 47
[119]*ibid*
[120]*ibid*

3.2. Creditor's Protection Trough Self-help Mechanisms: Conceptual Analyses

A contractual or self-help mechanism is one way by which the liability of the corporate debtor toward its creditor is regulated among the parties through contractual provisions. [121] Self-help creditor protection mechanism views the firm as a nexus of contract.[122] This is to mean, parties involved in the affairs of the company including creditors enter into a multitude of contracts voluntarily and each party aims at maximizing its benefit. [123] Accordingly, corporate creditors as a third party who contract voluntarily, they seek to gain the adequate protection through the terms of the contract with the debtor. [124] As a result, the issue of corporate creditor protection is a primary matter of contract rather than of company law. These contractual mechanisms of protection allow creditors to be provided with the level of protection they think to be adequate. [125] In assessing the adequacy of such contractual protection, creditors take into consideration several factors including the probability of default of the debtor company. [126]Further, these mechanisms have the effect of preventing rather than curing problems related to creditor's protection as it prevents corporate creditors from concluding a contract which from the very beginning does not adequately indicate the nonperformance by the debtor.[127]

Creditor self-help mechanism as it can be understood from its naming, it's not available for involuntary creditors as they have no prior contractual relationship with the company before they become a creditor. [128] The same is true for weak creditor who has less bargaining power to negotiate terms of a debt contract. Davies one of the scholars of company law names those creditors who are not able to make use of these self-help mechanisms as non-adjusting creditors.[129] Since the self-help mechanisms are regarded as inherently costly, these mechanisms may not be available for weak creditors as they cannot afford one of these costly mechanisms to protect themselves. Besides, Davies rightly mentions that, though the self-help mechanism is

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[121]*id*, p. 48
[122]*ibid*
[123]*id*, 62
[124]*ibid*
[125]*id*, p. 48
[126]*ibid*
[127]*id law*, p.8
[128]Supra note 13, Peter O. Mülbert, O 'A Synthetic View of Different Concepts of Creditor Protection', p. 376
[129]Pau L.Davies, *Introduction to Company Law,* 2nd edition, Oxford University Press, USA, 2010, p.71(hereinafter Paul Davies, *Introduction to Company Law*) P.68

successful in restricting the opportunistic behavior on the part of the controller of the company, but it creates scope for the opportunism on the part of the secured creditor against the unsecured creditor. [130]

Though it is regarded as very costly, self-help mechanisms are beneficial as they provide more flexibility for creditors by allowing them to have the protection they need for instance by charging the interest rate they consider appropriate for the risk of default. [131] Hence, the creditor's self-help mechanisms help to restrict the scope for the opportunistic shareholder's behavior which the limited liability doctrine permits.[132] Further, it also allows corporate creditors to exercise an adequate level of monitoring and thereby allows them to renegotiate or modify their credit terms. [133] In the section below, self-help creditor protection mechanisms will be discussed.

3.2.1. Types of self-help mechanism of corporate creditor protection

Under this title, a bird's eye view of some of the types of self-help will be discussed. Fromthe typical example of this self-help mechanisms, mention can be made to third party credit insurance, debt covenant, obtaining collateral and personal guarantee, interest rate.

Starting from covenants, covenants are the contractual instrument by which the corporate creditor and debtor enter into a contract and determine the terms and the condition of a loan agreement that reflects the probability of default.[134] Covenants can be classified as negative and positive covenants.[135] Negative covenants are those covenants that restrict debtor company from performing activities that will dilute the interest of creditors.[136] This can be illustrated by the restriction of dividends or other payments to shareholders, a clause on debt restriction, avoid over-indebtedness or illiquidity, limitations on assets of the company's sales, on the granting of guarantees or loans, the conclusion of contracts above a certain value, acquisitions of other

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[130]*id*

[131]*Supra note* 19, ElisTarell, *Basel ii and the protection of creditors in company law*, p. 48

[132]*Supra note* 129, Paul Davies, *Introduction to company law*, p. 71

[133]*Supranote* 9, Elis Tarell, *Basel ii and the Protection of Creditors in Company Law*, p. 48

[134]*id*, p. 63

[135]Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring,*Dissertation, University of Glasgow, [unpublished] availablehttps://eleanor.lib.gla.ac.uk/record=b2613428,January 2008, p. 135(hereinafter Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring*)

[136]*Id*, p. 65

companies.[137] Whereas, positive covenants refer to those covenants which oblige a debtor company to maintain a certain situation of the debtor company, for instance, by keeping the legal status of the company, maintain the financial health of the company, keeping certain staff, or requiring some other positive performance by the corporate debtor.[138]

The other mechanism for protection of corporate creditor included under self-help is obtaining collateral or security in the form of a proprietary claim over the assets of the debtor company. Literatures suggest that obtaining collateral is the most effective form of creditor self-help mechanism.[139]This is because of the fact that if there is sufficient collateral the creditor can be in a firm position to avoid the risk of ex-post opportunism on the parts of the debtor company.[140] Also, collateral unlike that of the covenant, it entitles the holder a property right which has the effect of self-enforcing in the sense that the creditor can take a measure to enforce such security upon debtor defaults.[141] Collateral gives three principal legal functions for the secured creditors. First, it gives a priority right for the holder over unsecured creditor as well as over other secured creditors who rank junior to him, second, it provides an efficient and cheap enforcement method and thirdly it limits the debtor's property right over collateral.[142] Despite its attractive benefits, collateral has also these downsides as it is not a type of protection which all creditors rely on. [143].

The other self-help mechanism for the protection of creditors is through mandatory insurance mechanisms. Under this self-help mechanism, the creditors are provided with an additional guarantee for the risk of payment default. What is interesting about this mechanism is it is not only the debtor that would monitor the performance of the debtor company rather the insurance company would also play an important role in monitoring the performed activities against which the debtor has agreed to insure himself.[144] Accordingly, the insurer would price increased risk with higher insurance premiums and in turn, shareholders will refrain from engaging in risky

[137]*Ibid*
[138]*Ibid*
[139]*Supra note* 9, Elis Tarell, *Basel ii and the Protection of Creditors in Company Law*, p. 86
[140]*ibid*
[141]*ibid*
[142]Supra note 135 , Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring*, p.136
[143]*ibid*
[144]*ibid*, p. 89

business activities to avoid the payment of higher insurance premiums.[145] However, it is a very costly mechanism for creditor to safeguards their interest.

In addition to the mechanisms mentioned above, there are also other self-help mechanisms that the creditor can contract with the debtor company. Creditors may also have a contractual right to secure the right to nominate the director to the board.[146] This is true in case where creditors occupy a disproportionate negotiating power. [147] The right of the creditor to appoint a director enables them to secure representation within the governance of the debtor company. [148] Further, the nominee director may provide a useful channel of information to the corporate creditor about the company's activity. [149]

Protection through interest rate is also another method of self-help mechanism designed against risk associated with credit. Under this mechanism, before a certain amount of interest rate is determined creditors first should carry out a risk assessment of the debater company to ascertain whether they should extend credit and if the credit is provided as to what amount of interest rate they will charge.[150] The interest rate in this method is expected to include not only rental payment for the borrowed capital but also risk compensation in case when a debtor defaults.[151] Retention of title clause is also another self-help mechanism which mostly used by the trade creditor.[152]

The other self-help mechanism for corporate creditor protection is requiring personal guarantees from the controllers of the debtor company. [153] By this self-help mechanism, creditors protect themselves from the debtor's default by requiring guarantees from shareholders or the managers of the debtor company. In case where the debtor company failed to pay its debt, the creditor can take an action against the controller of the company such as shareholder or manager. What is

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[145]*Id* p.136
[146]*id*, p.137
[147]*Ibid*
[148]*Supra note* 129, Davies, *Introduction to Company Law*, p. 67
[149]*id* p. 68
[150]*Supra note* 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p.92
[151]*ibid*
[152]*Supra note 46*, Andrew Keay, Company Directors' Responsibility to Creditor, p. 19
[153]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p, 95

interesting from this self-help mechanism is it signals the financial stability of the debtor company to corporate creditors and thereby lower the interest rate charged to credit. [154]

3.3. Statutory type of creditor protection

After the widespread of limited shareholder liability in the mid-nineteenth century, the protections of creditors have been the most important concern of company law.[155] Statutory protection of creditors is those protections of corporate creditors are embodied at different laws such as company law, insolvency law, and common law rules on lifting the corporate veil. This protection generally aimed at providing both ex- ante and ex-post protection for corporate creditors. [156] Under the perfect capital market, creditors are not in a need of legal protection as they can protect themselves by perfect information and through perfect financial contracting.[157] This is because, under this condition, their contracts will provide them with interest rate returns perfectly correlated to the risks that they bear and shareholders could never benefit at creditors' expense by undercapitalizing a company.[158] However, in the real capital market, there is asymmetry of information which place creditor at their disadvantage. The legal or statutory rule which protect creditor is generally can play an important role in identifying the weakness of real market for corporate credit. [159]

Using mandatory rules for the protection of corporate creditors is justified for the following reasons. Firstly, as has been said earlier, the self-help mechanism of corporate creditor protection is not applicable for all types of creditors depending on creditor's incapability of contracting or the lack of barraging power. In such circumstances, protection through mandatory rules will be an indispensable way for creditors who lack barraging power to protect themselves. [160] Secondly and most importantly, it is efficient to use mandatory legal provisions for bargaining between company and creditor as it is less costly for legislators to specify a particular form of

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[154]*Ibid*
[155]*Supranote* 2, ReinierKraakman et al, anatomy of corporate law, p. 465
[156]*Supranote* 2, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 47
[157]John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', *The Modern Law Review*, Vol. 63, No. 3 (May, 2000), pp. 355-378: Wiley on behalf of the Modern Law Review, p. 357(hereinafter John Armour, 'Share Capital and Creditor Protection)
[158]*Id*. 357
[159]*ibid*
[160] Davies, Introduction to Company Law, p. 71

opportunistic behavior than for each set of contacting. [161] This is because, from the economic perspective prevention of the opportunistic behavior of the company by mandatory rules serves to lower transaction costs. [162] Thirdly, the protection of corporate creditors through mandatory legal rules helps to solve the collective action problems among creditors. [163] This is to mean when there are different types of creditors; the behavior of individual creditors may found inconsistent with their interest as a group. As a result, creditors can be protected by legal rules, not from the debtor but from each other. [164] Beyond all, the statutory type of creditor protection is helpful to save creditors from the cost of writing such a term into their loan contracts as this protection can be taken as an implied covenant.[165]

Under this category of protection, several different mechanisms are available. These include mandatory disclosure, capital-related requirement, the subordination of shareholder claims, rules governing opportunism towards creditorswithin corporate groups, rules that reduce opportunism on the part of company controllers which takes the form of adding to the company's liabilities at a time when there is little hope that there will be sufficient assets in the company's coffers to meet the creditors' claims when they fall due.[166]In the section below, an attempt will be made to discuss some of them.

3.3.1. Mandatory Disclosure

3.3.1. 1. Conceptual Overview

Among different legal strategies upon which creditor can be protected, mandatory disclosure of a company's information is an indispensable mechanism of creditor protection. Disclosure is the communication of economic information whether financial or non-financial concerning the company's financial position and performance.[167]All theories on corporate governance agree that

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[161]*ibid*

[162]Supra note 13, Peter O. Mülbert,O 'A Synthetic View of Different Concepts of Creditor Protection, 377

[163]John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', p. 362

[164]*ibid*

[165]*Id*p. 6

[166] Supra note 13, Peter O. Mülbert,O 'A Synthetic View of Different Concepts of Creditor Protection, p. 378

[167]GeorgiosGeorgakopoulos, et al, 'Mandatory Disclosure and Its Impact on the Company Value' Vol. 6, No. 5, *Canadian Center of Science and Education International Business Research*, 2013, p.1 (hereinafter GeorgiosGeorgakopoulos, et al, ''Mandatory Disclosure and Its Impact on the Company Value'')

information released by the company is important for creditors and investors to make sound investment decisions. [168]

Information disclosed by companies can be two-fold. These are voluntary and mandatory disclosure. Starting from the first one, voluntary disclosure as the name denotes when companies on their motive decide to disclose more information than required because they believe that this will benefit them from improved reputation, less regulatory intervention, and enhanced stock liquidity.[169] Mandatory disclosure on the other hand exists when regulatory authorities impose an obligation on companies to disclose a minimum amount of information in corporate reports.[170]

3.3.1.2. Function of mandatory disclosure

As Elis Tarelli mentions in his dissertation, mandatory disclosure has these three important economic rationales.[171] First, Mandatory disclosure plays an important protective function by promoting the confidence of both equity and debt investors as creditors generally do not contract without obtaining information from the borrowerabout its financial performance. Second, it helps to counterbalance the negative consequence of market failure in the credit market as a result of incomplete information. Thirdly, mandatory disclosure prevents the disclosure of false or misleading information on behalf of the producer of information. As compared with its counterparts i.e. voluntary disclosure, mandatory disclosure by requiring the management to use the same formats and standards to disseminate information, it enables to reduce the costs of processing and comparing information provided to acquire an accurate and balanced view of the company.[172] Besides, mandatory disclosure is also important to reduce the cause of unfairness from uneven distribution of information as theoretically all investors would obtain the same information at the same time and in the same format. [173] Beyond this, mandatory disclosure is of particular significance for small creditors who lack the bargaining power to force the voluntary provision of information.[174]

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[168]*ibid*
[169]*ibid*
[170]*id'*, p. 1
[171]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 101
[172]*id*, p.102
[173]*id*, p. 103
[174] They may even be non-adjusting creditors who are not in the position to alter contract terms depending on the risk of default, see EliaseTarell, *Basel ii and the protection of creditors in company law*, p. 103

The protection of creditor through the instrumentality of mandatory disclosure is more justified by the reason that those who lend money or advance credit should benefit from having reliable financial information relating to the company.[175] Thus, corporate creditors of any type can be in a better position to assess the process of screening to determine whether it is worthwhile to transact with the debtor company, and on the ongoing credit relationship, creditors can assess periodically the creditworthiness of the debtor to transact.[176] Mandatory disclosure helps to address such an agency problem by requiring the disclosure of a quality of information. [177]

3.3.1.3. Types of information needs to be disclosed

The average creditors are interested in the disclosure of information which indicates the company's level of borrowing, the amounts of capital, its cash flow, and any other information which enables them to calculate the appropriate risk premium.[178] But this does not mean that creditors and shareholders need completely different sets of information to protect their interest.[179]Concerning the type of information that companies are obliged to disclose for corporate creditor protection, ReinierKraaman explains in his book that all jurisdictions require that the names of corporate entities should reflect their legal status through suffix. [180] Beyond that, companies are also required to file their memorandum in the public registers so that the outsider including creditors could know the basic information of companies.Not only this, many jurisdictions have improved their public registers in recent years to present such information in a more user-friendly fashion.[181] Not only this, many jurisdictions have improved their public registers in recent years to present such information in a more user-friendly fashion.[182]

Regarding the other type of information that the creditor needs to be disclosed, disclosure of the company's financial statement is an important one. Disclosing or reporting these financial statements has special importance to creditors as it provides information to make sound investment decisions and to effectively monitor the company's management.[183] In addition, the

[175]Supra note 19, Hanno Merkt,' Creditor Protection through Mandatory Disclosure, p. 97
[176]*ibid*
[177]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, 102
[178]*id*, p. 104
[179]*ibid*
[180]Supra note 2 Reinierkraaman*etal*, *Anatomy of Corporate Law*, p. 119
[181]*ibid*
[182]Supra note 19, Hanno Merkt, Creditor Protection through Mandatory Disclosure, p. 97
[183]TeferiDeyuu, Corporate Financial Reporting Legal and Regulatory Frameworks in Ethiopia, p. 57

financial statements serve as a mirror that reflects the financial position of operating strength or weakness of business concern as it indicates the profitability and financial soundness of a certain business enterprise.[184]

The financial statement has this objective of providing information about the financial position, performance, and cash flows of an entity that is useful to its user. Hence, companies are required to report their financial and operational performance to the stakeholder in general and creditors in particular through the instrumentality of corporate financial reporting.[185]

Financial reporting is nothing but it is all about communication of published financial statements and related information from a certain business venture to third party including shareholders, creditors, customers, governmental authority, and the general public.[186] The financial statement like balance sheets, income statements, profit, and loss account of the company and cash flow statement is the most common type of financial statements. [187] Let's see each of these financial statements and their associated benefit for corporate creditors.

Starting from the first one, the balance sheet is a statement of the company's assets and liability at any time showing whether its net asset value (assets less than liability) is positive or negative.[188] It shows the assets that the company control (fixed and current), the source from which their acquisition has been funded.[189] It also further indicates whether the company is using any loan capital alongside the owners' equity capital. [190] Besides, by showing information related to the income and expenditure over a given period of time (normally a year). The disclosure of the balance sheet enables to reveal whether the company is undergoing a business profitably or not.[191] If the creditors can access the balance sheet of the company, they are placed in a better position for instance to assess the solvency risk of the company. This is because if creditors

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[184]Saoudchayed , *Analysis of financial statements*, Muthanna University, 1st edition, 2020,p. 26(here in after Saoudchayed , *analysis of financial statements*)

[185]TeferiDeyuuAlemi and J. S. Pasricha, 'Corporate Financial Reporting Legal and Regulatory Frameworks in Ethiopia *'journal of accounting and taxation* Vol. 9(5), pp. 56-67, May 2017,p. 58 (here in after TeferiDeyuu, Corporate Financial Reporting)

[186]*ibid*

[187]Supra note 54, Li, Xiao, *Corporate Governance in the Context of Corporate Restructuring*, p.146 See also Companies Act 2006, section 82

[188]Supra note 114, Davies, *introduction to company law*, p. 116 see also Michael and Alan, Making creditors protection effective, p. 13

[189]Supra note 26 , Michael and Alan, Making creditors protection effective, p. 13

[190]*ibid*

[191]Supra note 54, Davies, *introduction to company law*, p. 116

know the source of funding for instance, the greater the proportion of funding that comes from creditors, the greater the solvency risk is thought to be.[192] However, it is difficult to rely on a balance sheet to show that the company can meet its obligation as they fall due. [193] Due to this limitation, the balance sheet test is regarded as poor guides, loosely defined, and potentially spurious.[194]

The profit and loss account of the company is also another financial statement which serves to show whether the resource of the company have increased or fallen as a result of trading activities over the past trading period (afterallowing for any capital introduced or withdrawn by shareholders).[195] By using this financial statement, incomes and gains are credited and expenses and losses are decimated to show the net profit or loss over a given period. [196] Not only this, the profit and loss account by is nature has this unique feature as it enables the organization to judge the performance of the factors of production and to take note of the expenses for the future of the organization.[197].

The other important financial information that needs to be disclosed is cash flow statement. It shows how net cash holdings have changed over the time, distinguishing between the main sources and applications of the balances. [198] Further, it presents the generation and use of 'cash and cash equivalents' by category (operating, investing, and financing) over a specific period.[199] It provides users with a basis to assess the entity's ability to generate and utilize its cash. According to Michael and Alan, predicting future cash flows and (the possible insolvency) lies at the heat of creditor protection. [200] This is because the most relevant information takes the form of cash forecasts and cash flow forecastsare sufficient and necessary to define solvency. [201] As such creditors are interested in knowing the fact that the company will be able to pay its debts as

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[192] Supra note 26, Michael and Alan, Making creditors protection effective, p. 13
[193] *ibid*
[194] *ibid*
[195] *Ibid*
[196] Supra note 184, Saoudchayed, analysis of financial statements, p. 26
[197] *ibid*
[198] *ibid*
[199] IFRS overview 2019, PwC, available https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-19/pwc-ifrs--overview-2019.pdf p.49 last June 20 -20
[200] Supra note 26, Michael and Alan, Making creditors protection effective, p. 6
[201] *ibid*

they become due. [202] Accordingly, cash flow statement plays important role for creditors as they can use the cash flow analysis of the company's accounting records to measure the company's liquidity or its ability to make short term payment.[203]

The other important financial information which is important for creditor protection is the publication of the result of the solvency tests either theliquidity test or the balance sheet test, or a combination of both.[204] The solvency test by itself involves strong debate as to which type of test I.e. liquidity or balance sheet is more accurate.[205] The periodical disclosure of capital is also financial information to make sure that whether the company has sufficient capital that it is not undercapitalized. [206] But there is no universally agreed criterion as to the sufficient level of capital for a certain company considering their risk profile. [207]

Once these financial statements are prepared, it is through the instrumentality of publication that creditors are aware of its existence. It has always seemed obvious that one of the major purposes behind the publication of financial accounts has been the protection of creditors particularly after limited liability became thenorm.[208] In addition to that publication, the companies may also be required by law to file their financial statements with relevant authority.[209]

The disclosure of the above-cited financial information calls for standardization. Standardization is nothing but it explains the use of an identical format for disclosure to facilitate a comparison of the data disclosed. [210] The standardization of the balance sheet, income statement, and interim reporting might contribute to reducing the cost incurred by interested party in general and creditors in particular in processing disclosed information.[211] About the frequency to disclose this financial information, the Elis Tarellienlightens that, shareholders need more information on a more frequent basis unlike that of a creditor. This is to mean; creditors are only interested on

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[202]Saoudchayed, Analysis of financial statements, p. 12
[203]*ibid*
[204]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 107
[205]*Ibid*
[206]*ibid*
[207]*id*, p. 108
[208] Supra note 56, Maria Elena, fraudulent and wrongful trading, , p. 13
[209]Supra note 184, Saoudchayed, Analysis of financial statements, , p. 1
[210]Supra note 19, Hanno Merkt,' Creditor Protection through Mandatory Disclosure, 115
[211]*ibid*

the disclosure of financial information which enables them to know the events that might threaten the debtor's solvency and thus trigger the creditors' reaction to that. [212]

3.3.1.4. The role of auditor in mandating disclosure

Before granting credit, trade lenders will usually make inquiries as to the credit status of the customer. [213] To facilitate this enquires; company law has deployed the verification of financial statements by a third party called auditor. Unless and otherwise the financial information prepared by the board of directors verified by the auditor, all the disclosure would be of little use.[214] Hence, the quality of mandated disclosures can be enhanced through verification by trusted third parties.[215]Accordingly, auditors are universally employed to verify accounting disclosures, and credit bureaus have become increasingly important in aggregating and disseminating information about borrowers' credit histories.[216]Related to the disclosure duty, companies except small-sized companies need to carry out an audit by an outside and professionally qualified third party.[217]This is because the qualifications of the auditor play an important role in the efficiency ofthe audit function.[218]

Generally, auditors are duty-bound to report whether the accounts present a 'true and fair' view of the company's financial situation. [219] Beyond this, the auditor is also required to ensure whether a financial statement of a given company reflects the applicable laws and accounting standards.[220]

In doing so, auditors are required to follow accounting standards, national and international to report the financial information. [221] That is why creditors as well as shareholders increasingly rely on them to verify the company's financial statements. To fairly accomplish this task, all

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[212] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 105
[213]Supra note 26, Michael and Alan, Making creditors protection effective, p. 6
[214] Davies, *Introduction to Company Law*, p. 118
[215]Financial term, available at http://en.m.investopedia.com /terms/i/ias.asp, 2020 last accessed on May 27, 2020
[216]*Ibid*
[217]*ibid*
[218]HelmiAbdulhameedBoshnak, *Mandatory and Voluntary Disclosures in GCC Listed Firms*, PHD Dissertation, Universityof the West of England, Faculty of Business and Law, January 2017,(unpublished, available at https://uwe-repository.worktribe.com/output/886480/), p.26 (herein after HelmiAbdulhameedBoshnak, *Mandatory and Voluntary Disclosures in GCC Listed Firms*)
[219]Supra note 129, Davies, *Introduction to Company Law*, p. 118
[220]Supra note 2, Reinierkraaman*et a*l , *Anatomy of Corporate Law*,, p. 122
[221] Davies, *Introduction to Company Law*, p. 118

major jurisdictions require auditors to be outsiders, independent and professional for publicly held traded companies and large closely held companies. [222]

The investigation that could be done by the creditors about the financial situation of a would-be debtor company can be delegated to credit rating agencies (CRAs) as a get gatekeeper especially where debt is widely dispersed using securitization of bank loan. [223] Auditing a company's financial statement by gatekeepers is helpful to increase the quality of financial account as they care about their reputational capital which gives them a competitive advantage as being auditors.[224]

Regarding to the accounting standard that the company needs to adopt in disclosing financial statements, governments of states adopts different reporting standard. The first accounting standard is called international accounting standards (IASs**).** IASs are the first and the older accounting standard issued by the International Accounting Standards Board (IASB).[225]This board is an independent standard-setting body situated in London.Later on, in 200l, the IASs were replaced by the International Financial Reporting Standards (IFRS).[226]

International Financial Reporting Standards (IFRSs) is standard issued by the International Accounting Standards Board (IASB) up to October 2018.[227] IFRS is a standard which applied for the profit-oriented entities and gives financial information about the performance, position, and cash flow that is useful to in making financial decision used by a range of users such as existing and potential investors, lenders, and other creditors, and other users: employees, suppliers, customers, governments and their agencies, regulators and the public in making a financial decision. [228] Currently, most countries across the world adopted IFRSs with the view to enhance the transparency and comparability of the financial information that they produce. [229] In most countries, the adoption of this IFRS is mandatory for the listed company. [230] As the International Accounting Standards Board (IASB) has no power of enforcement in any country, the

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[222]Reinierkraaman*et a*l , *Anatomy of Corporate Law*, p. 122
[223]*Id*,p. 122
[224]Supra note 129, Davies, *Introduction to company law*, p. 118
[225] Financial term, available at http://en.m.investopedia.com /terms/i/ias.asp, 2020 last accessed on May 27, 2020
[226]*Ibid*
[227]IFRS overview 2019, available https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-19/pwc-ifrs--overview-2019. p.6
[228]*ibid*
[229]Supra note 218, HelmiAbdulhameed, *Mandatory and Voluntary Disclosures in GCC Listed Firms*, p. 24
[230]*ibid*

applicability of IFRSs depends upon national regulatory bodies.[231] To enforce and ensure the compliance of these accounting standards, the independent audit.[232]

3.3.1.5. Disclosure under the OECD principle of corporate governance

The OECD principle of corporate governance is developed by the OECD Council Meeting at the Ministerial level which intended to help policymaker to evaluate and improve the legal, regulatory, and institutional framework for corporate governance.[233] This principle is applied to publicly traded companies of both types including financial and non-financial.[234] The OECD principles is also have an important feature in recognizing not only the interest of shareholders but also other stakeholders and their important role in contributing to the long-term success and performance of the company.[235] Besides, the principles nowadays serve as a benchmark for policymaker and individual jurisdiction as minimum standards and best practices for sound corporate governance framework.[236]The OECD Principles of Corporate Governance comprises six major principles of which the one is concerned about disclosure and transparency. According to this principle, "the corporate governance framework should ensure that timelyand accurate disclosure is made on all material matters regardingthe corporation, including the financial situation, performance,ownership, and governance of the company. "[237]One thing that needs to be underline at this juncture is, the disclosure requirement imposed on the company is not expected to place an unreasonable administrative or cost burden. [238]A detailed discussion on this principle of the OECD will be made on the upcoming chapter.

3.3.1.6. Making Disclosure Effective

In conclusion, to make the protection of creditors effective through mandatory disclosure, scholars suggest the following four prerequisites.[239] These are first the information that should

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[231]*ibid*
[232]*ibid*
[233]OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris.http://dx.doi.org/10.1787/9789264236882-en, p. p.9(herein after OECD (2015), G20/OECD Principles of Corporate Governance)
[234]*ibid*
[235]*ibid*
[236]*ibid*
[237]OECD Principles of Corporate Governance, 2004, p.22(hereinafter OECD Principles)
[238]Supra note 213, OECD (2015), *G20/OECD Principles of Corporate Governance*, p.37
[239]Supra note 9, ElaisTarell, *Basel ii and the protection of creditors in company law*, p. 107

be easily available. To ease such disclosure, companies may use for instance the internet so that the creditors can access that relevant information from the company's home page. This helps creditors to get a more up to date picture of the debtor's company finance than a printed report published several months after the financial figure were complied. [240] Creditors can also visit the commercial register. Secondly, the information provided to the creditors needs to be renewed periodically for instance in every three months or something like that. But disclosure made on the annual publication may not play much of an informational role. [241] This is because, by the time when information is disclosed, it has already become outdated and may not reflect the real financial situation of the company at the time the reports were published.[242] Thirdly and most importantly, the information needs to be standardized in the sense that all the companies should use the same standardized methodologies and calculation and reporting format to enable a comparison of data. Lastly, the information should be easily understood and can be easily acted upon it accordingly. The creditor may not be in a position to understand all the technical financial information. In such a case, it is good to make the information easily understandable for any creditor type.

In addition to these prerequisites, for the disclosed information to serve as a helpful tool of creditor protection, the information disclosed needs to have a quantity and adequateness. This means, the information disclosed needs to fulfill the requirement of materiality. If certain information can enable a creditor to take a different decision that he would have made had he not had such information, it fulfills the test of materiality.[243]

3.3.2. Legal Capital Rules

The second type of protection statutory protection of creditors is through legal capital rule. Before embarking on rules on legal capital[244], let's say a few words about the conceptual

[240]*id*, p. 110
[241]*ibid*
[242]Supra note 9, Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 109
[243]*Id*, p. 112 Materiality of information is related to relevancy and accuracy of information, hence to the quality rather than to the quantity of information disclosed. Also, the disclosure should at the same time be comprehensive.
[244]These rules are commonly referred to as legal capital rules, share capital rules. See Natalia Andreicheva, *The Role of Legal Capital Rules in Creditor Protection: Contrasting the Demands of Western Market Economies With Ukraine's Transitional Economy*, LLM thesis, The London School of Economics and Political Science, Law

overview of the term legal capital itself. As we know the company's capital can be sourced from either from its investors who contribute initially in the form of cash or in-kind in return for the company's shares or from creditors by issuing debt or by loan financing provided by banks and other lenders. From such sources of capital, it is only the equity funds provided by shareholders are treated as legal capital. [245] Simply put, capital is the value of the consideration which the shareholders have provided to the company in exchange for their shares. [246]Hence, legal capital can be understood as the amount of a company's equity that cannot legally be allowed to be used for purposes other than business.[247] This means it cannot be distributed to its shareholders either through a dividend or any other means of distribution.

Thus, legal capital is nothing but per value of common stock and a stated value of the preferred stock that a business has sold or otherwise issued to investors. [248]According to Kraakman, legal capital has this conceptual understanding: "In "par value" jurisdictions, legal capital is at least the aggregate nominal ("par") value of issued shares (typically lower than the issue price), and maybe extended to the entire issue price (so-called "share premium") [249]Rules designed to regulate capital in a company is used to protect different interests. Among other things, a common justification of share capital provision is that they protect corporate creditors from the abuse of limited liability by shareholders. [250] That is why legal capital rule is taken as an entry price for the advantages of limited liability and as a tool for companies to signal their initial credibility to potential creditors.[251]

Department, January 2009[unpublished], p. 12 here in after (Natalia Andreicheva,, The role of legal capital rules in creditor protection)

[245] Law teachers, free law study resources, available at http://www.Lawteachers.net/free–law-essay/company–law/theconceptoflegalcapital , last accessed on 22- Apr-

[246] Davies, *introduction to company law*, p. 74

[247] Accounting tools available at http://www.accounting tools.com/articles/what is legal capital.html accessed on 22-apr-2020

[248]*Ibid*

[249]Supra note 2, Reinierkraaman*et al,* Anatomy of Corporate Law, p. 124 legal capital may consist of three things: the value received by a company corresponding to the nominal value of the shares; any additional consideration, which will be reflected in the share premium account and capital redemption account used to maintain the capital yardstick if shares are repurchased out of profits.

[250]William W. Bratton,' Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, *European Business Organization Law Review* 7: 39-87 39 TMCSSER PRESS DOI© 2006. ,p. 41(hereinafter William W. Bratton,' Bond Covenants and Creditor Protection)

[251]Supra note 244, Natalia Andreicheva, *The role of legal capital rules in creditor protection*, P. 35

Legal capital rules serve both the interest of larger and smaller or weaker creditors. For the larger creditors who are placed on firm position to contractually impose an additional requirement, legal capital rules serve to reduce the transaction costs. [252] For small or weaker creditors who lack bargaining power for preferred terms, legal capital requirement offers standardized credit terms for sparsely worded individual agreement. [253] In addition to these benefits, legal capital rules play an important role for the following reasons.

- ❖ It helps creditors by addressing the problems of information asymmetry in corporate credit markets. [254]
- ❖ Serves as barriers to withdrawing money from a company to a creditor's disadvantage. [255]
- ❖ They serve as a means to cushion creditors to absorb loss before the risk thereof is shifted and serves as an alarm for a creditor. [256]

That is why some legal experts take the legal capital rule as the most efficient way of limiting distribution before insolvency by providing less manipulation than the solvency test used in the common law legal system.[257].

On the contrary, scholars are criticizing legal capital rules for the following reasons

- ❖ Buffer capital that the company can avail itself in case where there are difficulties as capital can be consumed in the course of trading.[258]
- ❖ It imposes unjustifiable burdens on companies by making their financial structures inflexible, cumbersome procedures for instance by forcing them to pay for expert reports and legal advice. [259]

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[252]*id*, p. 35
[253]*ibid*, p. 35
[254]*id*, p. 37
[255]John Armour, 'Legal Capital: An Outdated Concept?' ,*European Business Organization Law Review*, 7: 5-27 5 © 2006 T.M.C.ASSER PRESS DOI10.1017/S156675290600005X , 2005, p. 2 (herein after John Armor, Legal Capital: An Outdated Concept), p. 2
[256] Kohn Geen, 'The European Company Law Action Plan Revisited: An Introduction'*, ECGI- law Working Paper No.140/2010*, Leuven university press, 2010, Available at amazon.com, p. 32(hereinafter Kohn Geen, the European company law action plan revised)
[257] id *p.33*
[258] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 112
[259]Luca Enriques Jonathan R. Macey,' Creditors versus Capital Formation: The Case against the European Legal Capital Rules', Volume 86 Issue 6,*Cornell Law Review*, *September 2001* p. 185(hereinafter Luca Enriques Jonathan R. Macey,' Creditors versus Capital Formation)

- Legal capital rules also blamed for its difficulty in assessing the creditworthiness of the company or its net asset position.[260]

There are three possible ways in which a legal system could use the concept of legal capital to protect creditors. The first one is setting or prescribing minimum capital requirement, second restricting on payment out to shares also known as capital maintenance regime and thirdly triggering actions that must be taken following serious depletion of capital (in the near of insolvency).[261] At the section below, an attempt will be made to discuss each of them.

3.3.2.1. Minimum capital requirement

One of the basic important rules included under the umbrella of legal capital rule is the requirements for companies to have a certain amount of capital before a company commences trading. According to Peter O. Mülbert, minimum capital requirements come in two forms: initial and ongoing minimum capital.[262] An initial minimum capital requirement as the name tells it is a capital collected in the process of raising equity capital which a public company is normally required to reach acertain minimum capital yardstick before commencing trading[263]whereas the ongoing minimum capital is provided by prescribing recapitalization rule.[264] This is to mean, in case when the company's net assets fall below a threshold of 50 percent of the company nominal capital, the shareholder will have to recapitalize.[265] In terms of its acceptance, the minimum capital requirement nowadays taken as an outdated concept, and thereby many jurisdictions try to abolish from statutory regulation of the company. However, Europe is among jurisdiction that imposes minimum equity investment thresholds for access to the corporate form.[266]

On the question of whether minimum capital requirement provides any real protection to creditors or not, different legal scholars have come up with different arguments. Starting from the merit of the minimum capital requirement, minimum capital rules, coupled with anti-

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[260] Supra note 256, Kohn Geen, *the European company law action plan revise, p.36*

[261] Supra note 2Reinierkraaman*et al*, *Anatomy of corporate law*, p. 124 see also the anatomy of corporate law, 2004 ed, p.83, 2004

[262]Supra note 13, Peter O. Mülbert,O 'A Synthetic View of Different Concepts of Creditor Protection, p. 385

[263]Reinierkraaman*et al* , anatomy of corporate law, p. 14

[264] Peter O. Mülbert, O 'A Synthetic View of Different Concepts of Creditor Protection, p. 387

[265] *ibid*

[266]Reinierkraaman*et al* , anatomy of corporate law, p. 124

avoidance requirements, can be understood as providing a sort of guarantee to creditors that those using the corporate form will at the very least have a certain amount of their own money at stake.[267] This is due to the fact that minimum capital requirement imposes an 'entry price' for Limited liability. Besides, it helps also to indicate the seriousness of entrepreneurs by showing that they commit a non- insignificant amount of money to their project or it may simply reflect a desire to avoid potential liability for trading while insolvent.[268] This will help in effect to erect barriers against the creation of dubious corporations with an unreasonable amount of backing by shareholders.[269] Beyond this, minimum capital requirement plays an important role through the amelioration of the position of non-adjusting creditors.[270] Accordingly, the fact that minimum capital requirements are imposed on a company regardless of contractual relationship with creditors can be seen as a positive feature to protect weaker creditors who lack sophistication and bargaining power to negotiate with the company.[271]

On the other side of the coin, the minimum capital requirement is criticized as a rule which does not have adequate protection for the following reasons. First, there is difficulty in quantifying the amount of minimum capital requirement as there is no meaningful link between the riskiness of the businesses and the amount of legal capital prescribed by statutory law.[272] This is due to the fact that ; any chosen amount would be arbitrary and inappropriate, and economically doubtful as it is difficult to determine ex-ante the amount of capital necessary to cover a firm’s future liabilities.[273]Secondly and most importantly, regardless of the amount chosen, a minimum capital requirement will not prevent a company from becoming insolvent as a result of the ongoing poor management or poor business condition. This is because the raised amount does not stay firmly in place throughout a company’s lifetime as minimum capital requirements do not restrict a

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[267]Supra note 255, John Armor, legal capital an outdated concept, p. 7

[268]Reinierkraaman*et al* , anatomy of corporate law, p. 125

[269] Supra note 259, Luca Enriques and Martin Gelter, How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law, *ECGI- Law Working Paper No.63/2006* ,2006 p. 23

[270] John Armor, Legal Capital an Outdated Concept , p. 9

[271]Supra note 244, Natalia Andreicheva, *The role of legal capital rules in creditor protection:*, p.13

[272] Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 52

[273]*ibid*

company's trading decisions and cannotprevent the company from making decisions that lead the company to losses.[274]

3.3.2.2. Capital Maintenance Rules

It is true that in the business venture where there is a privilege of limited liability; there should be a legal means which protect corporate creditor from controller's opportunism. To that effect, all modern company law system has rules which restrict the freedom of the company controller to move assets out of the company for the benefit of shareholder and to the detriment of creditors. [275] These rules are called capital maintenance. Capital maintenance rules are nothing but it is a rule which requires the preservation intact of the value of shareholders' contribution. [276]

This rule is the other approach to use the concept of legal capital. Unlike that of minimum capital requirement which required to have a certain amount of capital, the capital maintenance rule leaves the companies free to raise any amount of capital both before commencing business and subsequently, but then it uses the contributed capital as a mechanism to regulate the freedom of controlling shareholder. [277]

This approach is long adopted and has been developed as a doctrine called capital maintenance[278] through a series of judicial interpretation[279] in company law cases in England.[280]. As a result of the development of this doctrine in England and some other common law countries, companies were started to regulate for the interest of creditors and the investing public. [281] This results a

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[274]Supra note 244, Natalia Andreicheva, *The role of legal capital rules in creditor protection*. P. 14

[275]Supra note 229, Davies, *Introduction to Company Law*, p. 84

[276] Oxford English Dictionary, 2nd ed. (Oxford: Clarendon Press, 1989) Vol. IX,

[277]Supra note 229, Davies, *Introduction to Company Law,* p. 78

[278] This rule are also termed as capital unchangeability in Japan, see Elis Tarell, *Basel ii and the protection of creditors in company law*, p. 85

[279]For instance, the case of, Jessel M. R., in *Flitcroft's Case*, indirectly stated about two aspects of the doctrine of capital maintenance-" i) the creditors have a right to see that the capital is not dissipated unlawfully; and ii) the members must not have the capital returned to them surreptitiously. In other cases, *TrevorvWhitworth***,** The House of Lords held that share buyback was *ultra vires* the company declaring that the company could not purchase its shares. This case has been subsequently applied both by the courts and in statutory provisions. These case laws have been the foundations of the doctrine of capital maintenance. See Md. Saidul Islam, the Doctrine of Capital Maintenance and its Statutory Developments: An Analysis, p. 47

[280]Md. Saidul Islam, The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis, *Volume IV (2013) ISSN 2218-2578 The Northern University Journal of Law, 2013*p. 49 see also Davies, inroductio to company law, p. 78(here in after Md. Saidul Islam, The Doctrine of Capital Maintenance)

[281]NdivhuoRabuli , *Capital Maintenance Rule and Distribution Focusing on Section 46 And 48 of Companies Act of 2008,* Masters of Corporate Law, University of Pretoria, *2016*,p.8 (herein after NdivhuoRabuli , Capital Maintenance Rule and Distribution),

shift of approach from the American model which took view that creditors providing debt financing are capable of protecting through proper contract negotiation.[282] This doctrine remains to be the foundation stone of the company laws in countries.[283]

The doctrine called capital maintenance is a collection of rules designed to ensure the maintenance of capital obtained by the company's subject to the exigencies of the business, for the benefit and protection of the creditors of the company.[284]Under this approach of legal capital, the value of capital collected from shareholders is used to set a limit for the value of assets which the company can distribute to its shareholders. [285] Accordingly, the capital maintenance rules are attempted to ensure that the company's assets represented by shareholders' equity investments, is not removed from the company through returns to Shareholders.[286]If there is a distribution to shareholders, it might reduce the company's net assets and makes it more exposed to the risk of insolvency.[287] The definition of distribution has this broad understanding to include transactions whereby the assets are transferred directly and directly for less than market power.[288]Given that, a profit should not be recognized unless a business has at least maintained the amount of its net assets (capital) during an accounting period.[289] To that effect, the company cannot return its capital to its shareholders unless there is a special procedure or approval of the court and the liability of shareholders in respect of capital not paid up. [290]

The very important function of the capital maintenance rules is that it can deter the ex-post action by shareholder or directors acting on their behalf which reduce the expected value of the corporate asset.[291]In addition to that, capital maintenance rules also play important role in ensuring the priority rule by preventing shareholders from getting back their equity ahead of

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[282]*ibid*

[283]*Supranote* 34,Md. Saidul Islam, the Doctrine of Capital Maintenance and its Statutory Developments, p. 48

[284]*id*: p. 49 see also Davies, introduction to company law, p. 78

[285]Supra note 229, Davies, *Introduction to Company Law*, p.78

[286]Supra note 244, Natalia Andreicheva, The Role of Legal Capital Rules in Creditor Protection, p. 14

[287] John Armor, The legal Capital An Outdated Concept? p. 3

[288]Supra note 288, John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', *The Modern Law Review*, Vol. 63, No. 3 (May, 2000), pp. 355-378:, p. 357 (hereinafter John Armour, 'Share Capital and Creditor Protection)

[289] John Armor, the Legal Capital an Outdated Concept? p. 3

[290]Supra note 34,Md. Saidul Islam, the Doctrine of Capital Maintenance and its Statutory Developments, p. 48

[291] John Armor, The Legal Capital, an Outdated Concept, p. 5

creditors.[292] By doing so, capital maintenance rules help to address the conflict between creditors and shareholders interest.

Despite the fact that, there is a question as to the effectiveness of such rules as the best way that can be devised for the protection of corporate creditors. As Davies in his book mentioned, in recent years the capital maintenance rules have received a bad press in the UK.[293] Among the major criticism directed against this rule, the first one is the margin above net asset required for lawful distribution is set by a historical figure, i.e. the amount of the company happens to have raised from its shareholders in the past.[294] Secondly, the capital maintenance rule cannot regulate the loss of assets incurred through trading loss like the minimum capital requirement. [295] There are different rules that boil down from the doctrine of capital maintenance. These are, prohibition of purchase of own shares,, the prohibition of giving any kind of financial assistance to acquire company's share, dividends must not be paid to the shareholders except out of the distributable profits; and where a public company suffers a serious loss of capital, a meeting of the company can be called to discuss the issue.[296] An attempt will be made in the next section to discuss some of these rules.

I. Dividend Distribution

Distribution can be made in a variety of forms. Among these different types of distribution, the payment of dividends to shareholders is the most common one. A dividend is a form of distribution of a value of shares holders that may be made either in cash or in kind. According to Davies, a dividend is nothing but a payment usually made by the company to shareholder which its amount is expressed as a percentage of the nominal value of shares.[297] Form wise, the most usual way to distribute dividend is made in cash once a year or in the case of listed companies usually twice a year.[298] However, dividends can be made in the form of tangible assets and also in the form of shares.

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[292]Supra note 244, Natalia Andreicheva, The Role of Legal Capital Rules in Creditor Protection, p. 28
[293]Supra note 229, Davies, *Introduction to Company Law*, p. 84
[294]*ibid*
[295]*ibid*
[296] Davies, *Introduction to Company Law*, p. 80
[297]*ibid*
[298] These forms of dividends are known mainly in closely held companies. see Davies*, introduction to company law*, p.80

As a matter of principle, as companies are business ventures established for profit, they can distribute dividends to its shareholder. What company law generally restricts is the distribution of dividends which impairs the company's legal capital to prevent asset dilution.[299] Dividend which impairs legal capital exists when there are distributions that exceed the difference between the book value of the company's assets and the amount of its legal capital, as shown in the balance sheet.[300] By restricting dividends which impair legal capital, the company law prevents shareholders from diluting the pool of assets. [301]

To appreciate the amount of permissible distribution, there are two internationally acknowledged bottom-line test. [302] These are balance sheet test and cash flow test. According to the first test, a company can make a distribution to its shareholders if the company's assets exceed its liabilities immediately after a distribution has been made. [303] Accordingly, it is a test that requires that the company's asset will still fully cover or exceed its liability following the contemplated distribution. [304] The balance sheet test is regarded as a trustworthy test that allows companies to see what assets they need to keep to cover their liability. [305] As the creditor's interest in the company is staying solvent, the balance sheet test assures that by indicating whether the company's assets fully cover its liability after the distribution though it does not guarantee future solvency. [306]Whereas for the cash flow test, the company can distribute dividends if the company will be able, as a going concern, to meet its debts as they fall due for the foreseeable future. [307] Unlike that of the balance sheet test, this test indicates the future solvency of the company which is more reliant on business strategy than current assets and liabilities.[308]Accordingly to determine the solvency of the company via this test, one should look at the company's current financial

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[299]Supra note 2Reinier kraaman*et al,Anatomy of Corporate Law*, p. 125
[300] Davies*, Introduction to Company Law*, p. 80
[301]Reinierkraaman*et a*l, *Anatomy of Corporate Law*, 2004 ed, p. 83
[302]*ibid*
[303]*ibid*
[304]Supra note 255, Kohn Geen, *The European Company Law Action Plan Revise, p.40*
[305]Tilsammen, Protecting Creditors and Investors - Capital Maintenance in the European Private Company, p. 47
[306]*Id*, p. 48
[307]Supra note 13,Peter O. Mülbert, O ‘A Synthetic View of Different Concepts of Creditor Protection, p. 388
[308]Tilsammen, *Protecting Creditors and Investors - Capital Maintenance in the European Private Company*, LLM theses, OsloUniversity, [unpublished] p. 47(here in afterTilsammen, *Protecting Creditors and Investors*)

obligations and any which will be due in the near future. [309]And creditors would want to be protected against excessive distributions leading to future insolvency as well.

Apart from the distribution of dividends, there are also restrictions made on distribution. For instance, in many jurisdictions, such as Germany, the U.S., and the UK, the restriction on distributions is applied to undervalued transactions between a company and its shareholders, which the courts may characterize as "disguised distributions."[310] Beyond that, there are a variety of transactions the purpose of which is to conceal the fact that assets of the company are distributed to the shareholders.[311] These transactions include the excessive remuneration of shareholders who serve as managers of the company, the extension of loans offered by the company to its shareholders with an interest rate which is well below market price, the supply of assets of the company as collateral for loans taken out by the shareholders and the like. [312]

The next logical question that needs to be addressed by company law is what are the consequences of unlawful distribution if any? An unlawful distribution whether unlawful at common law for being out of capital or unlawful because in breach of statute (either no available profit and or some breach of the accounting requirement) is ultra-virus and void and cannot be ratified by the shareholder. [313]In addressing this point, it would be plausible to observe the experience of different states. Accordingly, European company law appears to recognize that shareholders acting *bona fide* should not be held liable for a wrongful distribution. However, those shareholders who knowingly or should have known the wrongful distribution are liable to bring back what they have taken from the company.[314] In the same fashion, according to Sec. 847 CA 2006 of UK, if the members of the company knows or has a reasonable ground to believe that the distribution of dividend violate the rules, the shareholder will be liable to repay it or the value of in-kind distribution to the company. [315]

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[309]*ibid*
[310]Supra note 308, Reinierkraaman*et a*l , Anatomy of Corporate Law, p. 126
[311] Gerhard Wagner EBOR 7), 'Distributions to Shareholders and Fraudulent Transfer Law', *European Business Organization Law Review*, 2006, p. 222(hereinafter Gerhard Wagner, 'Distributions to Shareholders and Fraudulent Transfer Law)
[312]*ibid*
[313] Brenda Hannigan, Company Law, Oxford University Press, p, 518
[314]Supra note 308, Tilsammen, 'Protecting Creditors and Investors, p. 48
[315] Andreas Cahn and David C. Donald, Comparative Company Law, p. 226

II. Share buy-backs

A company's assets can also be distributed to shareholders through the company buying back or redeeming its shares. As both share buyback and dividend have the effect of distributing the company's asset, the same principle is applied to public companies about these two.[316]

A share buyback is not only the issue of capital maintenance but also it raises the issues of corporate governance and market regulation. [317] From the perspective of capital maintenance which is the main focus of this paper, share buyback has a strong implication on creditor's protection as it transfers company assets to the members from whom the shares are purchased (shareholder).[318] Accordingly, buying back the company's shares amounts to the return of money from the company to shareholders as the money would leave the company permanently and the company would receive nothing of financial value in return. Due to that, share buyback like other forms of distribution, it brings the danger of default payment for unsecured creditors as the company's assets available for repayment of debts might be reduced. [319] Besides, share buyback also can reduce the number of available shareholders who could potentially be held for unpaid debts if the veil of corporate were priced. [320] Due to such negative effects of share buy back on the company's capital, it was thought to be inconsistent with the capital maintenance rules to permit a company to buy back its shares at all.[321] However, it has now been realized that capital maintenance does not require a complete ban on share buy-backs rather it is subject to strict regulation[322] as it might help to improve earnings per share of the company resulting in positive effects on the price of the company's shares by reducing the number of outstanding shares. [323]

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[316]Supra note 229,Davies, Introduction to Company Law, p. 80

[317] Andreas Cahn and David C. Donald, Comparative Company Law, p. 241

[318]*Id*, p. 242

[319]*id*, p. 243

[320]*ibid*

[321]Supra note, 229, Davies*, introduction to company law*, p. 80

[322] Share buyback rules applied more leniently for private companies unlike that of publicly traded companies which are subject to strict regulation. For instance, the Second Company Law of EU Directive as amended in 2006 allows a member state to completely forbid issuer repurchases, when, the net assets are being lower than the sum of subscribed capital and required reserves. On the other hand, when the member state of EU permits share buyback, the directive allows so with a condition that it is only fully paid-up sharesmay be purchased. Further, the authorization of the generalmeeting must specify a maximum and minimum price and cannot have a duration exceeding five years. [322] Concerning the voting right of repurchased shares, the directive further stipulates that all voting rights attaching to repurchased shares remain suspended. in Germany, those circumstances that needs to be fulfilled to effect share repurchase is first there should be authorization (maximum duration five years) from the general meeting, with the maximum and minimum price being specified, and the requirement that shares purchased under the authorization not exceed 10 percent of capital – even if the actual holdings were to be less thanthat

To not offending the capital maintenance rule, there are two ways by which the share buyback can be financed. [324] First, they may be funded out of the proceeds of the issuance of fresh shares in which case the consideration received for the new shares simply replaces the repurchased shares in the company's legal capital. From a commercial point of view, this has the advantage that issuing shares raises cash for the company but costs it nothing. [325] Secondly and more commonly, the share buyback can be funded without the issuance of new shares by unwanted assets out of distributable profit.

III. Capital reduction

Requiring adequate safeguards is a common way of protecting creditors against wrongful reductions of capital, especially those in effect being distributions to shareholders.[326] Before dealing with capital reduction and its consequential effect on creditor's protection, it good to appreciate what is reduced in the reduction of capital. As Davies rightly mentioned, to say there is a reduction of capital, the value attributed in the balance sheet to the consideration received by the company in exchange for its shares must be reduced.[327] Simply put, what is meant by reducing the company's capital is reducing the legal capital entry into the company's account.[328] The legal capital entry can be reduced in several ways including by reduction of the nominal value of the issued shares, cancelation of shares, reduction in share premium account, cancelation of the requirement for a shareholder to pay the unpaid amount on shares. [329] Accordingly, one can simply understand that reduction of capital does not involve necessary a

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because of cancellation or resale of shares. In UK, share repurchase is possible upon the fulfillment of first, the buyback can only out of distributable profits or the proceeds of a fresh issue of shares made for this purpose,and public companies must create a restricted reserve for any purchased shares shown on the balance sheet as an asset. As required by the Directive, only fully paid-up shares may be repurchased. Unlike these countries, the US state laws do not provide any detailed set of requirements for the repurchase of own shares. see Andreas Cahn and David C. Donald , Comparative Company Law, p. 242

[323] Andreas Cahn and David C. Donald , Comparative Company Law, p. 242

[324]Supra note, 229, Davies, *Introduction to Company Law*, p. 80

[325] Alexis Mavrikakis*et al*, *Business law and practice*, College of Law Publishing, Braboeuf Manor, Portsmouth Road, St catherines, Guildford GU3 1HA, 2011, P. 199(herein after Alexis Mavrikakis et al, *Business law and practice*)

[326]Supra note 308. Tilsammen, Protecting Creditors and Investors - Capital Maintenance in the European Private Company, p.35

[327] Davies. *Introduction to company law*, p. 83

[328] David Kershaw, *company law in context text and materials*, 2[n] ed. oxford university press,2006 , p. 856(here in after David Kershaw, *company law in context text and materials*)

[329] Id. *p. 856*

reduction of the assets of the company by returning them to the shareholders, though that may be involved in particular cases. [330]

From the perspective of the capital maintenance point view, capital reduction has a great concern for corporate creditor's protection. This is because all capital reductions necessarily diminish the fund available to creditors for their repayment. [331] Besides, the reduction of capital may involve a return of assetsto the shareholders which endanger the legal capital which creditors look after. [332] This result by reducing the share capital yardstick and thus allowing for easier distribution hurdles, the reductions can help create distributable assets for the potential return of capital to shareholders.[333] That is why in most jurisdictions, creditors who can show a real likelihood' that thereduction would result in the company being unable to discharge theclaim or debt when it falls due to become in effect entitled to have their debts repaid or secured as a precondition for court approval. [334] Provisions on capital reduction thus provide an example of how capital maintenance rules can mitigate the debt-equity conflict. This is done by prescribing conditions to be met and procedures to go through before a capital reduction.[335]Had it not been for these procedures of capital reduction, a company without distributable profits could successfully resort to opportunistic distribution strategies to return capital to shareholders using the freed-up assets.[336]Hence, restrictions on capital reductions can help to address the issue of capital return to shareholders through 'milking the property' distribution strategies. [337]

Rules governing the raising of share capital can have also some concern for creditor protection as it provides creditors with the protection against a form of misrepresentation. [338] This is to mean, the company's capital recorded in its public documents can mislead if the assets have never actually been contributed to the company. Accordingly, in a case when the company raises

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[330] Davies. *Introduction to Company Law*, p. 83

[331]Supra note 244, Natalia Andreicheva, The Role of Legal Capital Rules In Creditor Protection, p. 32

[332] Davies, *introduction to company law*, p. 83

[333]Natalia Andreicheva, The Role of Legal Capital Rules in Creditor Protection, p. 32

[334] For instance, the Second EU Directive imposes procedural safeguards involving court approval coupled with an entitlement for objecting creditors to have their claims paid out or secured. See Natalia Andreicheva, The role of legal capital rules in creditor protection, p. 32 And Davies, introduction to company law, p. 83

[335]*id*, p. 36

[336]*ibid*

[337]*ibid*

[338] John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?', *ESRC Centre for Business Research University of Cambridge*, Working Paper No. 148, December 1999, p.13(hereinafter John Armour, 'share capital and creditor protection)

capital by allotting shares, a number of rules apply so a so make sure that shares may not be issued at discount to their per value.[339] Not only this, whenever there in kind of contribution to increase the capital of the company, due consideration should be given for proper valuation of the property contributed. Under the section below, an attempt will be made to discuss the valuation of in-kind contribution.

IV. Valuation of In-kindContribution

Shareholder can make their contribution to acquire the company's share either in cash or when the consideration comes in some forms other than cash, in kind. In case when there is an in-kind contribution either for shares issued on the formation or in subsequent through capital increases, a proper valuation of that property contributed is necessary to know the exact value of shares in exchange for the company's share. In most jurisdictions particularly in Europe, the valuation of non-cash consideration made in public companies is subjected to an independent expert's valuation.[340] The rationale behind for such requirements is that non-cash contributions verified by independent experts is taken as a response to problems of information asymmetry in the corporate credit markets, as they 'publicize to investors the value of the assets that shareholders put into the company, and seek to ensure that this information is truthful'.[341] Accordingly, independent experts valuation of non-cash consideration is made to ensure that the assets supplied are worth the par value of the shares.[342] For that reason, rules on valuation of contribution in kind provide creditors with information about the value of the assets contributed by the shareholders to the company which might be relevant to lending decisions.[343]

In-kind contributions and its valuation have important concerns for creditor's protection as well as shareholder of the company. This is because, unlike a one-time acquisition of an asset, the acquisition of an overvalued asset as contribution in-kind has a leverage effect.[344] Hence, the shareholder would not only engage in the one-time sale of an overpriced asset but would

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[339]*Ibid*

[340] Luca Enriques Jonathan R. Macey,' Creditors versus Capital Formation: The Case against the European Legal Capital Rules', Volume 86 Issue 6,*Cornell Law Review*, *September 2001* p. 114(hereinafter Luca Enriques Jonathan R. Macey,' Creditors versus Capital Formation)

[341] Supra note, 244,Natalia Andreicheva, The Role of Legal Capital Rules in Creditor Protection, p. 36

[342] Jonathan Rickford, reforming capital Report of the Interdisciplinary Group on Capital Maintenance, p. 934

[343]Supra note 255, John Armour, 'share capital and creditor protection, Share capital and creditors protection, P. 364

[344]MarousLutter, *legal capital in Europe*, European company and financial law review, 2006, p.60(here in after MarousLutter, legal capital in Europe)

continue to receive excessive profit in the long term which would correspond to his level of exaggerated participation in the company rather than to the actual value of the contributed asset.[345]

Some commentators argue that the expert valuation of in-kind contribution is time-consuming and inconvenient in urgent cases, and expensive.[346] It is expensive because it gives rise to potential liability on the evaluators who are invariably insured which the expense is born by the company itself. Due to such problems, it puts significant barriers on public companies using equity financing. They also further state that, from the creditor's perspective requiring an expert report on contributions in kind is of little benefit to them as evaluation techniques leave experts with a very wide range of discretion.[347]Not only this, it is really hard to make sure the independence of the expert even if they are appointed by the third party like a judge as they don't want to risk losing her current or prospective clients by acting too independently in the valuation of non-cash consideration.[348]

V. Financial Assistance

Theoretically speaking, the concept of financial assistance is not necessarily limited and linked to the legal capital rule as a company may not give financial assistance even if it does so out of distributable profits.[349] As a part of the legal capital rule, the rule on financial assistance provides that a company may not give financial assistance towards the purchase of its shares, whether before or after the purchase.[350] Hence, finical assistance by the company is the other typical way to distribute the company's capital to its member to acquire its shares.[351] Assistance purchase may take these different forms including giving of a gift, lending money to the purchaser of its shares, giving a guarantee and security to the seller of its shares. [352] Thus, financial assistance

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345*ibid*
346*Supranote* 21,Jonathan Rickford, Reforming Capital Report of the Interdisciplinary Group on Capital Maintenance, p. 934
[347]*Supranote* 259, Luca Enriques , Jonathan R. Macey,' Creditors versus Capital Formation, p. 1187
[348]*ibid*
[349]*Supranote* 229, Davies, Introduction to Company Law, p. 86
[350]*ibid*
[351] Financial assistance according to CA 2006, s 677' means a gift, loan, indemnity, guarantee, assignment, or other transaction by which the acquirer is directly or indirectly put in funds
[352] Identifying prohibited Financial assistance in Australia, by Catherine Beahan, available at https://www.lexology.com/library/detail.aspx?g=4fb1a006-3c5b-4c32-af29-dab2011d22ae last accessed on May 9, 2020

could include so many transactions that may amount to assistance so long as it materially reduces the company's asset. [353]

According to John Armour, the original rationale behind the regulation of financial assistance is the prevention of asset stripping take over in case when there is a transaction whereby a purchaser of the share would borrow heavily to buy a majority holding of the target company's share for cash and then rapidly sell the company's asset using a proceeds to discharge the loan.[354] This in effect results an indirect return of capital whereby the old shareholders are cashed out at the expense of the creditors. [355]

In sum, financial assistance by the company is prohibited to prevent the resource of the company being used to assist a purchaser and thereby prejudicing the interest of creditors. [356] By doing that, companies in which its shares are acquired through financial assistance effectively prefers shareholder to the determinant of the creditors and hence offend the rules of capital maintenance. [357] To avert such danger on corporate creditors, company law provides a general limitation on companies on their power to assist a person financially to sell their share.[358]

3.4. Corporate creditors protection in the near of insolvency

The term vicinity of insolvency refers to a point of time called " zone of insolvency" to express the situation when the company is found in financial distress and may well be moving from solvency towards and even into insolvency. [359]In thenear of insolvency, the company's financial stability has become deteriorated to the extent that insolvency becomes imminent. [360] Consequently, the creditors' position in the company's liquidation will be affected by the

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[353]Supra note 325, Alexis Mavrikakis et al, *Business law and practice, p.* 193
[354]Supra note 288, John Armour, Share Capital and Creditor Protection, p. 368
[355]*ibid*
[356]StanyoDinov, 'The Concept of Legal Capital does not in principle provide an efficient effective protection to creditors' *International Corporate Rescue*, vol.12, 2015, no 5 p. 307(herein after Stanyodinov, 'The Concept of Legal Capital
[357]*Ibid*
[358] For instance, if one can see CA 2006, s 678 of UK, The general rule is that a *public* company cannot give a prospective or an actual shareholder any financial assistance to enable him to purchase shares in the company
[359] Andrew Keay'The shifting of directors' duties in the vicinity of insolvency', International *Insolvency Review*, 24 (2). 140 - 164. Available at, https://doi.org/10.1002/iir.1236, p. 2 (hereinafter Andrew Keay, 'The Shifting of Directors' Duties in The Vicinity of Insolvency')
[360]*Id*, p. 3

director'sacts. [361] The important question at this juncture is what kind of protection creditors have in the time when a company approaching insolvency and what duty is owed by directors of the company. [362]In the vicinity of insolvency, it is common for many jurisdictions to impose 'creditor-regarding duties[363] on company directors.[364] These creditors- regarding duties are originally developed as a part of common law and are now well covered under the Companies Act of 2006 and statutory provisions on wrongful and fraudulent trading found in the Insolvency Act 1986.[365]

A typical example of this is looking at section 214 of the UK's insolvency act 1986 which stipulation against wrongful trading. According to this provision, " if directors know or ought to conclude that there was no reasonable prospect of thecompany avoiding going into insolvent liquidation then unless they take every step tominimize the potential loss to creditors they will be personally liable to contribute to the company's losses if the company does end up in insolvent liquidation." Under this provision, while the company is an ongoing concern but directors continue trading regardless of financial difficulties; they will be liable for creditor. The law under art214(1)1 ittries to impose an obligation on the director which is measured objectively and enforced by the liquidator on behalf of the creditor. Beyond that, wrongful trading remedy may only be instituted by the liquidator of the company and is applicable 'in the course of a winding-

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[361]*ibid*

[362] In dealing with the situation of a company approaching insolvency, several jurisdictions provide different responses with due regard to the protection of creditors. Among those, experiences shows that in a significant number of jurisdiction particularly in Europe when the company is in the vicinity of insolvency, the director is obliged to file insolvency proceedings within a certain period of time when company becoming insolvent, if not, the director could be held liable personally in tort for losses sustained by their company and its creditors and other states like German obliged the board to cease making any payment. In EU Second Company Law Directive, after a serious loss of capital (when the net assets falling below half the company's legal capital), the public companies are required to call a shareholders' meeting to consider dissolution or other appropriate measures. Not only this, but several European jurisdictions have also adopted rules which mandate those running companies either to obtain fresh equity finance or cease trading when a certain level of reduction of net assets has occurred.[362] In such circumstances, the legal capital rule is serving as a cushion for creditors and thereby encouraging earlier liquidation or insolvency proceedings. [362] If there is early liquidation or insolvency proceeding, shareholders may have not enough time to act opportunistically to the determinant of the creditor's interest. See Reinierkraaman*et al* , Anatomy of Corporate Law, p. 127

[363] when we say creditor-regarding duties, it refers to a collective tool whereby creditors can be represented through a liquidator or an administrator acting on behalf of the company, see Natalia Andreicheva, The role of legal capita rules in creditor protection, p. 42

[364]P.L. Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency', 7 *European Business Organization Law Review*(2006) p. 301 at p. 309.(herein after P .L. Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency)

[365]Supra note 244, Natalia Andreicheva, The Role of Legal Capita Rules in Creditor Protection, p. 42

up. But what is difficult under this provision is it is difficult for the liquidator to determine the point from which directors might be liable.According to GautamSundaresh, the point at which there is “no reasonable prospect that the company would avoid going into insolvent liquidation” clearly arises much after a company can be said to have entered the zoneof insolvency.[366]

The other act which makes the director liable for creditor is the act on fraudulent trading. According to this act, if the director undertakes any kind of business of the company with the intention to defraud creditors, they will be personally responsible for the debts of the company.[367] As far as the liability is concerned, a director who defraud creditor commits a criminal offense and can be madecivilly liable.[368] One thing that needs to be underlined here is that there is no individual action taken by a creditor against a company rather it is a collective type of remedy by the liquidator who is acting in the interest of creditor. [369] The basic difference between wrongful trading and fraudulent trading mainly lies in the burden of proof. Accordingly, in case of fraudulent trading, the intention of the director to defraud creditors needs to be proven whereas in the wrongful trading it is sufficient to prove that the director negligently decided to carry on trading at a time when there was no prospect of the company recovering. [370] Hence, proving wrongful trading is much easier than that of fraudulent trading as fraud involves dishonesty which is a kind of opportunistic behavior that is difficult to prove.

[366]GautamSundaresh,’ In Whose Interests Should a Company Be Run? Fiduciary Duties of Directors during Corporate Failure in India’: Looking to the West for Answers, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 291 (2019), Volume 8 Issue 2, Available at: https://repository.law.umich.edu/mbelr/v ol8/iss2/4, p. 332(hereinafter GautamSundaresh,’ In Whose Interests Should a Company be Run?)

[367]*Supranote* 56, Maria Elena, fraudulent and wrongful trading, p. 14 see also section 213 of the Insolvency Act 1986

[368]*Supranote* 229, Davies, *Introduction to Company Law*, p. 88

[369]*ibid*

[370]*Supranote* 56, Maria Elena, Fraudulent and Wrongful Trading, p. 14

CHAPTER FOUR

CREDITOR'S PROTECTION UNDER ETHIOPIAN SHARE COMPANY LAW: A CRITICAL LEGAL ANALYSIS IN LIGHT OF INTERNATIONALRECOMMENDATIONS

4.1. Introduction

This chapter is devoted to discussing those legal issues surrounding the protection of corporate creditor as it is provided under the Commercial code of the Ethiopian and other relevant legislations.This chapter will have two parts. the first part will specifically expound the basic right of corporate creditors embodied under the above-cited legislationand the second part will point out the shortcoming of the law in addressing some of the basic rights of corporate creditors. In dealing with the inadequacy of the Ethiopian company law, a specific reference is made to the mandatory disclosure right of corporate creditor and some legal capital rules. Under the umbrella of the legal capital rules, a special emphasis has given for the rules of minimum capital requirement, capital maintenance rules, and rules which address the opportunistic behavior of shareholder against corporate creditors has been discussed. In assessing the legal protection conferred to corporate creditors under Ethiopia share company law, the OECD principles on corporate governance and the doctrine of capital maintenance has been used as a parameter.

4.2. Part one: Corporate Creditor Protections under Ethiopia Share Company Law

4.2.1. Corporate creditor protection at the formation of the company

Among different activities done by a company that might endanger the legitimate interest of creditor, the fraudulent or carless practice in the formation process of Share Company is the one.[371] To address this problem, the Ethiopian share company law provides some safeguards at the formation stage. Accordingly, in case when there is a defect in the formation of the company either due to lack of consent, duress, fraud, and any other legal requirement relating to the formation of the company, the law does not deny the legal personality once the publication, as

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[371]SeyoumYohannesTesfay, 'on formation of a share company in Ethiopia'Journal of Ethiopian Law, Volume 22, Issue 1, Jul 2008, p. 102 – 127 , p. 125(herein after Seyoum 'on formation of a share company in Ethiopia')

well as registration, has been complied. [372] Stating differently, any kind of defects in the formation of the company will have no consequence on the legal existence of the company so long as the company is the registered one. The law under 324 (2) provides that where the non-compliance with the formation requirements endangers the interest of creditors or shareholders, the court may, upon their application, order the dissolution of the share company or take provisional measures it deems necessary. As one can easily understand from the reading of such provision, creditors of the company will have a kind of right that have in the dissolution process if their interest is affected upon the giving of legal personality. [373] Under such circumstances, one can understand that the law might even force a person whose consent is vitiated to make the promised contribution to the extent required by the interest of a third party in good faith and have recourse against the party at fault.[374]

4.2.2. Legal capital rules and the protection of creditor under Ethiopian share company law

Under this section, an attempt is made to point out some of the protection of corporate creditor vested by the commercial code regarding the legal capital rules. As has been stated earlier in chapter two, legal capital rules are rules that regulate the manner how the capital of the company needs to be protected for the protection of corporate creditors. In support of this, legislator lays down a variety of rules designed for the protection of corporate creditors. As it is well understood from the reading of article 304 of the com code, it is only the assets of the company that meets the liabilities of a share company. Accordingly, it is good to know what constitutes "asset" under the com code.

Assets of the company constitute what the company generally owns including the original contribution from a shareholder in terms of per values of share in addition to that of premium (if

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[372]*Supranote* 4, Com code, article 324
[373]*Supranote* 371, Seyoum 'on formation of a share company in Ethiopia, p. 125
[374]*Id*, p. 125. At this juncture, it is good to state one case stated by Seyum in his article. [374] The case is between the National Bank of Ethiopia and the Horn International Bank Share Company. In this case, the court confirmed the revocation of a business license by the national bank which was issued based on false evidence but order the liquidator of the Horn International Bank Share Company to pay its creditors. In this case, the formation of the company was indeed defective as the license provided by the national bank was found false. But such defects did not produce a retrospective effect to annul the company and the transaction entered in by it. Rather the court has indicated its position in favor of third-party creditor in good faith.

any). [375] Not only has this but the asset of the company also includedin various reserves created from the profit generated by the company itself. [376] It is these assets of the company available for the execution of creditor claims against the debtor company. That means the creditor's recourse against shareholders is limited so long as s/he has made a promised contribution.[377] But one thing that needs to be underlined here is capital is different from the asset of the company as the former only constitutes the original contribution of shareholders. I.e. the per value of all the shares bought by the shareholder. [378] As the security for the creditor, the law requires the capital of the company to be always fully subscribed. [379]By specifying this requirement, 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. [380] Having said this, the legal capital rules as embodied under the commercial code will be discussed in the sections below.

4.2.2.1. Minimum capital requirement as a mechanism of corporate creditor protection

Under chapter two of this paper, so much has been said about the merit as well as the demerit of prescribing minimum capital requirement as a mechanism of corporate creditor protection. One of the safeguards available to ensure the protection of corporate creditors is subscribing to a certain minimum capital requirement. Like many continental European jurisdictions, the Ethiopia commercial code stipulates a minimum capital requirement for the formation of share companies.[381] This is because, in the countries which flow the continental legal system, corporate capital plays a fundamental role in the relationship between the company and third-party creditors. [382] According to this provision, every shareholder wishes to form a share company should make available at least 50, 000-birr capital to commence business. One can say that the sum 50,000 birr paid at the formation of Share Company is taken as a price for the benefit or privilege of limited liability in Ethiopia as the role of minimum capital requirement is

[375]Supra note 371, Seyum, on the formation of a share company in Ethiopia p. 106
[376] See different types of reserves listed under art 453 of the com code and art 455
[377]Supra note 4, Com code, art 304(2)
[378]Seyoum 'on formation of a share company in Ethiopia, p. 106
[379] Com code, p. 312(a)
[380]Seyoum 'on formation of a share company in Ethiopia, p. 107
[381] Com code, article 306
[382]Supra note 6, Ermiase and Nega , *law of trader and business organizations*, p. 76

tied up with limited liability.[383] As literature point out, by prescribing the minimum capital requirement, the commercial code has tried to control undercapitalization and thereby protect the interest of stakeholders including creditors of the company.[384] The draft commercial code still maintains the minimum capital requirement provided under Article 306.[385] Let alone the adequacy of the amount provided, there is a question as to the effectiveness of providing the minimum capital requirement for the protection of corporate creditors. On the point of whether providing minimum capital requirement is effective means of creditor protection or not, there will be a section that entertains the issue.

4.2.2.2.Creditors protection by capital maintenance provisions under the Ethiopian share company law

Under this section, an attempt will be made to shed a light on those provisions of the commercial code which implies maintaining the intact of the company's capital and thereby protect the rights of creditors. As it has been stated in the previous chapter, there are different restrictions made on the shareholder's ability to withdraw capital from the company to maintain capital. Among those, detailed scrutiny will be made on those rulesof capital maintenance such as manner of dividend distribution, the redemption of shares rule, cross-holding as between companies, valuation of in-kind contribution and company capital reduction, and thelike.

I. Dividend distribution

As one basic right, shareholders of a given company seek a distribution of profit which might be made in a variety of forms. To settle the undesired conflict between shareholders and creditors of the company, an attempt is taking by company law to balance the right of a shareholder to have a periodic profit and creditors to get their debt paid. The commercial code of Ethiopia has provided provisions that try to balance the above-stated conflict of interest. To maintain the capital of the company, the law stipulates some requirement that needs to be fulfilled before any distribution is made to shareholder. Among these, the first requirement is it is only from the net profit that the dividend can be paid.[386] Mathematically, Profit for distribution is it is a profit for the financial

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[383]Supra note 371, Seyoum ‘on formation of a share company in Ethiopia, p.110
[384]Supra note 6, Ermiase and Nega , *the law of trader and business organizations* p. 76
[385] See the new draft commercial code, art 247
[386]Supra note 4, Com code, art 458(1)

year minus previous loss and additional revenue and any distribution from the reserve funds specially approved by the general meeting. [387]Simply put,

> (A profit for distribution= profit for financial year -previous loss + additional revenue and any distribution from the reserve funds)

By requiring dividends only from the net profit, the law tries to prevent a kind of fictitious dividend that hamper the very interest of creditors. At this juncture, it is good to remember that the law doesn't clearly state the form of distribution that can be made rather it left the decision to the general meeting.[388] Irrespective of any form of dividend either in cash, in-kind or in the form of shares, the law requires dividends to be obtained from the net profit. However, sometimes dividends can be distributed even where there are no profits.[389] This distribution is made in the form of interest either fixed or interim.[390] But this kind of distribution can only be made when the company is under is preparatory works and construction of the enterprise.[391]

The other requirement for payment of the dividend is the distributable profit should be shown in the approved balance sheet. [392] By requiring that, the law assures whether the profit is real or fictitious as the director to build their reputation might simply distribute dividends in the absence of net profit. Even more, the existence of such approval of balance sheet by general meeting by itself has not relieved directors, auditors, or general managers for being liable. If the distribution of dividends is made without the fulfillment of the above-stated requirements, the law indicates the effect of the violation of such a requirement. Accordingly, the person making a factious dividend is civilly and criminally liable.[393]

ii. Redemption of shares

Redemption or what we call it, in other words, buyback of shares is the one which has a great concern for the protection of creditors. Like many jurisdictions, the commercial code rather than prohibiting share buyback it regulates in a very strict fashion. This is because unless redemption

[387]*id*, art 452(2)
[388]*id*, art 458(3)
[389]*id*. Art 457
[390]*id* art 457(1)
[391]*id.* Art 457(2)
[392]*id* , art 458(1)
[393]*id* art 548(2)

of shares is subject to stringent regulation,it may jeopardize the very interest of creditor as it may end up with a reduction of capital which is the main security for creditor's repayment. Taking such a possibility of reduction of capital, the law under art 332 of the com code indicates those prerequisites for the company to redeem its shares. Before dealing with those prerequisites, it is good to entertain those circumstances by which the shares can be bought back by the company under the com code.

The first reason for the company to redeem its shares is in a case when the companies amortize its capital. Amortization of capital is nothing, but it is repayment of shareholders of the investment represented by their shares. [394] As it is indicated under art 483(3) of the com code, amortization is effected by the redemption of shares within the same class. But to protect the company's capital, it is only from profit and reserves that amortization of capital is permitted to be made. Even from the type of reserve, it is only from reserve other than the legal reserve that amortization is allowed to be made.[395] The second reason to buy back shares is in the case where the sale of the shares cannot be effected. In this case, the directors may order the redemption of shares and retain the amount paid up. To avoid any inconvenience, the law provides that the forfeiture of the shares shall not result in the reduction of capital.[396] The other reason for the company to redeem its shares is when the shareholder withdraws from the company as a result of a change in the object or nature of the company. [397]In such a case, redemption should be done at the average price which is proportionate to the company's asset. [398] The last but not the least ground by which the company can redeem its share is when the decision to this effect is made by the meeting of shareholders. [399]Again, in such circumstances, the company is allowed to buy back its shares only if the purchase price is from the net profit of the company and shares are fully paid. [400] But it should not be forgotten that buying back is possible without the prior

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[394]*Supranote* 6, Ermise and Nega*, the law of trader and business organization*, p. 119
[395]*Supranote* 4, Com code, art 483(2)
[396]*Id*, 483(5)
[397]*id*, art 463(1)
[398]*id*, Com code, art 463(1)
[399]*id*, art 332(2)
[400]*ibid*

decision of an ordinary general meeting when the preemption right is reserved for the company.[401]

The strict regulation of buying back shares is also extended to the prohibition of advancing grant on its own shares including loans to enable other third parties to acquire shares. [402] This is because in a case when there is a default payment of debts, it may call risk on the company's capital. As it is clear from the reading of this provision the law doesn't provide any exceptional circumstances unlike other jurisdictions.

iii. Cross holding as between companies

Like that of redemption of shares joint holding is strictly regulated so as to prevent fraudulent avoidance of the minimum capital requirements.[403]The commercial code under art 344 prohibits a company from holding shares in a particular second company if this company holds shares representing ten percent or more of the capital of the first company. Accordingly, the commercial code tried to minimize the evasion of capital by restricting cross-holding between two companies. In case when there is cross-holding beyond 10%, the law obliges companies to declare their holding to the then ministry of commerce and industry, now MOTI, and require the companies by agreement to reduce their holding to conform to the above-stated amount. [404] Not only this, but the law also mandates the ministry of commerce and industry to order the company possessing the smaller holding to dispose of that holding in case when their holding is the same [405]To that effect, each company shall reduce its holding to less than 10% of the company if one of them failed to dispose of its shares in the other. To make sure whether they have complied with such requirements or not, the companies need to furnish a sworn statement for the above MOT. The overall reading of this sub-article reveals how the law tries to regulate the act of cross-holding beyond 10 percentages. But whether this provision is sufficient enough to achieve the above-stated rationale of the law is doubtful and will be part of this paper concern in the upcoming section.

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[401]*id* art 332(3)
[402]*id*, art 334
[403]*Supra* note 6, Ermiase and Nega, *the law of trade and business organization*. p. 122
[404]*Supranote* 4, Com code art, 344(2)
[405]*ibid*

VI. Valuation in-kind contribution

Previously the lawunder article 315 stipulates that the valuation of in-kind contribution should be made by experts appointed by the minister of trade and industry and the member who contributes in kind is required to file a report made and sworn by these experts.[406]To make the valuation more reliable, the code also requires that the valuation report should indicate property contributed, the value given to each item, and the mechanism of valuation.[407]

In addition to this mechanism, the auditor as well as a director is required to verify and review (if necessary) valuation within six months from the date of valuation. Not only this, but the code has also device another mechanism of approving the valuation by subscribers meeting.[408] To rectify problems with overvaluation the lawunder Article 315(4) provide that, upon verification of the valuation, if it results in the devaluation of property at the least by 1/5 the value of the capital will be reduced accordingly and obliged the contributor to make good the difference or withdraw from the company. In such a case, capital is reduced by annulling the shares which are not representative of the actual value of the property.[409] But what is an important question regarding this sub-article is if the amount of devaluation is less than 1/5. The law remains silent on this issue but Seyume one of the writers on company law asserts the following words;

> Commercial Code Art 315(3) & (4), where the verification under these 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."

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[406]*Id*, article 315(1) See also the. The recently issued Commercial Registration and Licensing Regulation no. 392/2016 goes one step further and allows rights on intellectual property such as, patent, copyrights to be contributed as capital, upon authentication of shareholders' resolution to this effect by a public notary.

[407]*Supranote4*, Com code, article 315(2)

[408]*ibid*, article 321

[409]Supra note 6, Ermiase and Nega, *the law of trader and business organization* p. 83

Beyond all, to enable third parties including creditors as to the overall process of valuation, the code has made the above-stated report to be annexed to the memorandum of association so that third parties would have the chance to have a look and make an informed decision. But the business licensing and registration proclamation 980 repeal this provision of the law and thereby it gives the power to value the in kind contribution for the founder and that of the shareholders and for their agreement.[410]

VII. Increase and reduction of the capital

Increasing and reducing the company's capital can be triggered by different reasons. But as to the question of which of these two has an adverse effect on the protection of creditors, creditors are more vulnerable in the time of reduction of the capital as it is the value of their security to satisfy their claim is reduced. Under the Ethiopia share company law, reduction and increase of capital can be done in different ways. The creditor's interest is not as such affected by the increase of capital. the increase of capital is governed by art 464-483 of the com code. Under this section of the paper, an attempt will be made to discuss the reduction of capital in detail by taking into account its effect on creditors and their protection.

a. Reduction of capital

When the capital of the company is reduced to a certain level, the creditor's security is reduced accordingly. But it doesn't mean that it is only creditors are affected by the act of reduction of capital. Rather shareholders can be affected though there is a difference in the very effect of reduction. Taking into consideration a direct risk of default payment, the law tries to devise mechanisms that safeguard the very interest of creditors. Among these mechanisms mention can be made first the auditor should present their reports to the meeting as to proposed reduction. Secondly the memorandum of association of the companies should be amended and such reduction should be registered in the commercial registry together with the publication requirement. [411]

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[410] Supra note 38, See art 5(9) of the business licensing and registration proclamation no 980

[411] Supra note 4, Com code, art 484, 484, 485

The commercial code tries to regulate the reduction of capital from art 486-494. As can be understood from the reading of these provisions, the reduction can be initiated either the company faces losses or when the company is not in a state of loss.[412] Starting from the first one, the reduction of capital of the following loss is governed from art 487- 490.[413] In this type of reduction, creditors have no right to object reduction rather they can require security. Besides, the law indicates the manner of reduction in a case when it is initiated due to loss. Accordingly, the reduction can be effected by reducing per value of shares or by exchanging old shares for a lesser number of new shares. In such a case, the right of creditor is protected under art 489. According to this provision, for those creditors whose claim is not paid or has not given adequate guarantees for the payments of the claim before the publication of reduction, the creditor of such type can have the right to oppose the resolution which orders the payment of compensation for shareholders or he may oppose any distribution of profit until the capital is restored to the amount existing at the time when the claim originated.[414]The contrarioreading of this provision reveals that once a creditor's claim is already paid or has been granted by an adequate guarantee, he cannot oppose resolution on the reduction of capital. The same right is incorporated for a creditor in case when there is a reduction of capital below the minimum required by the law.[415]

Reduction not motivated by loss is regulated under art 492-494 of the com code. This type of Reduction of capital may result from overcapitalization. In such circumstances, the company may be interested to give back the collected amount to shareholders and reduce the capital accordingly.[416] Unlike the reduction of capital motivated by loss, in this case, the creditors can object to the resolution made to reduce the capital within three months from the date of publication of reduction. [417] However, to oppose such reduction, the percentage of reduction

[412]FekaduPetros, የኢትዮጵያየኩባንያህግ, 2nd edition, በፋርኢስትትሬዲንግኃላ.የተ.የግ.ማህበር, Addis Ababa, 2004a p. 110 Here in after FekaduPeterose, Ethiopian company law,)
[413] Com code, art 486
[414]*id*, art 489
[415]*id* ,art 490(2)
[416]Supra note 412, FekaduPetros, *Ethiopian company law* p. 111
[417] Com code, art 493

must exceed 10% of the capital. Hence, the court may disallow such an objection of creditors or order the company to provide adequate guarantees for the payment of a debt. [418]

VIII. Full subscription of capital and paid-up capital

Like many jurisdictions, our commercial code does not only fix a minimum capital requirement in advance but rather by requiring the subscription of the capital. Accordingly, Article 312 of the code indicates that the capital of the share company should be fully subscribed and ¼ of per value of the share should be paid and deposited in the bank. According to the expose de motifs, the drafter is in the opinion that "the Anglo- American concept of authorized capital may be advantageous in certain cases but it provides less security for creditors. I believe that in the interest of a sound commercial regime, Ethiopia should adopt the more severe rule of continental law"

According to the opinion of professor Esscarra, the major objective of this provision is to provide high security for a creditor. The requirement of the payment of ¼ per value of the share provides more protection for creditors than that of subscription of shares as there is nothing that provides more protection than capital that is actually paid. Putting differently, as the subscribed capital is payable up to five years from the formation of the company[419], the subscribed capital will not be of much importance to creditors as the collection of a subscription is likely to become difficult at the very moment the money is needed. [420] At this juncture, one can still question the sufficiency of this amount for the desired legal objective.

In addition to the paid-up capital, the company under the CommercialCode cannot be formed unless the shares are fully subscribed.[421] It has been also stated that the requirement of a full subscription of capital is related to the principle of capital maintenance.[422] This is because the full subscription of capital makes the capital of the company a stronger guarantee for the creditor as they can rely on the existence of the amount of the capital which is promised by a shareholder to contribute that much.[423] Hence, liability to meet calls for shares is one instance whereby the

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[418]*id*, art 493(2)
[419]*id*, art 342
[420]Supra note 371, Seyume, on formation of share company law, p. 111
[421] Supra note 4, Com code, 312(1)
[422]Ermias and Nega, the law of trader and business organization, p. 78
[423]*ibid*

capital of the company can be maintained. According to Art 342 of the com code, if there is unpaid capital the subscribers are required to pay in the time when there is a call.

Moreover, the code also requires that the amount of subscribed capital be specified in the memorandum of Association.[424] Once the subscribed capital is specified under the memorandum of association, it can be modified only in compliance with a variety of safeguards and formalities designed to protect both the shareholder and creditor as it is indicated under Arts 431, 484 to 494, 454,470 to 473 of the code. [425] By reading these provisions, one can easily understand the commitment taken by the code to protect corporate creditors. In relation to this, the law also stipulates a legal reserve requirement from Art.453-457, and in such cases, companies are required to have a reserve deposit made from the net profit. This basically will have two major objectives. First, to protect the capital not to be eroded by the cover of reserve and secondly, it may serve as, a backup for eroded capital.

4.2.3. Corporate Creditor Protection and Piercing the Corporate Veil

Under the Ethiopian commercial code, once the company acquired its legal personality,[426] it becomes a distinct legal person which can undertake various juridical activities by its own name.[427] The fact that the company is separate from the property interest will make liable for the debts it incurs.[428] These attributes of the company which limit the liability of the member are limited calls for the second basic feature of the company such as limited liability. As a result of this, creditors claim against the company is limited to the company's asset and cannot seek the satisfaction of their claim from members unless otherwise provided in the memorandum of association.[429] This protection of shareholders from the unlimited claim of the creditor is known as the veil or shell of a company. [430] By relying on such privilege, shareholders might act opportunistically to the determinant of the creditor's right. To control such opportunistic

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[424]Supra note 4, Com code, article 313(5)
[425]Supra note 371, Seyume, on the formation of share company in Ethiopia p. 111
[426] To acquire legal personality under the Ethiopian legal system, fulfilling those legal requirements embodied under article 223, 323, 324 is necessary
[427] The publication requirement did not practically exist as there is no commercial Gazette and recently the new registration and licensing proclamation (Proclamation No. 686/2010) has explicitly abrogated the requirement of publication.
[428]*Supranote* 44, EndalewLijalem, 'The doctrine of Piercing the Corporate Veil, p. 82
[429]*id*,p.83
[430]*id*, p. 84

behavior, the doctrine of lifting or piercing the veil has been developed in the common law legal system and thereby protects creditors by lifting the wall of the separate personality .[431]Generally speaking, the privilege of limited liability will no longer shield shareholders if the company is abused it, and thereby creditors of the company can have a direct claim against parties inside the wall,such asare managers, directors, and individual shareholders.[432] Accordingly, the commercial code of Ethiopia provides some grounds by which the wall of the limited liability can be pierced.

To have a bird's eye of this grounds by which the veil of the company can be pierced under the Commercial Code, the first to pierce the corporate veil is bankruptcy. As can be understood from the reading of Article 1160 of the code, if a share company is declared bankrupt, creditors can require the bankruptcy of 'any person' who has carried out the operations in a manner indicated under such provision. Hence, certain persons are liable for the debts of the company upon the fulfillment of these conditions. The first requirement identifies the person who could be liable i.e. any person who has carried out commercial operations on his own behalf.[433] The second requirement is the person must have disposed of the company's fund by considering the assets of the company as his own asset and used it for his own interest at the expense of the company. Last, but not the least, requirement under this article is the person must conceal his activity under the cover of the company. This is to mean the person must use the company as a shield to achieve his own purposes.[434] In conclusion, one can say that by fulfilling the above-cited three requirements, the law under this provision tries to extend the company's bankruptcy to any person regardless of the position they assumed in the company.

The director's failure to preserve the company's capital is also another ground under the commercial code to pierce the veil of limited liability. According to art 366 of the Commercial Code when the company's asset is found insufficient to meet the company's liability as a result of the failure of directors to discharge their duties diligently, the creditor can bring an action against

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[431]*ibid*
[432]*id*, p. 85
[433] The phrase on his behalf expresses the situation when the person carried out the business in his interest. See EndalewLijalem, 'The doctrine of Piercing the Corporate Veil,p.100
[434]*ibid*

them.[435] At this point, it is good to underline the fact that the directors' liability to the creditor is a kind of fault-based as it is only upon failure to preserve the intact assets of the company that the directors would liable for creditors.

The other ground to pierce the veil of limited liability under our Commercial Code is when the number of members of Share Company the reduced below the legal minimum. As one formational requirement, Share Companies in Ethiopia are required to have at least five members. [436] Beyond setting this minimum member requirement, the law under Article 311 provides the effect of non-observance of this requirement. Accordingly, the failure to maintain this required number led to the dissolution of the company and calls the liability of the members for the debts of the company. As a result, the creditors can apply for the dissolution of the company and make liable the remaining members of the company as long as they are aware of such reduction and takes no action after six months count from the reduction of members. The rationale behind why the law is curious about the reduction of the member of the company is by taking an assumption that if the member reduced bellow a legal minimum there would be danger of abuse of legal personality. [437] This is because when the member is reduced below five, there is a high probability that the company would be controlled by few even to the extreme by a single person and results in the violation of the principle of separate legal personality.[438]

The other ground by which the corporate veil can be pierced is in a case when there is an act of trade restraint. It is when a person uses the corporate entity to evade his obligations both legal and contractual commitments that trade restraint happens. Those companies that are utilized to evade obligations are so-called 'sham'or ‘façade**’.**[439] As a result, the corporate personality of the company will be pierced to make the human constituents directly liable. For instance, concerning the sale of business,Article 158 of the CommercialCode provides for a mandatory obligation upon the seller that he or she is prohibited from doing any act of competition which likely injure buyers.Similarly, the formation of a company might be to hide oneself from the performance of an agreed contractual obligation.The typical example of this is what is provided under article 30

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[435]Supra note 4, Com code, art 366(2)
[436]*id*, art 306
[437]Supra note 44, EndalewLijalem, ‘The doctrine of Piercing the Corporate Veil, p. 103
[438]*ibid*
[439]*Id*, p.33

that an employer may agree with his commercial employee so that the latter will refrain from operating a trading activity similar to his employer. Piercing the corporate veil is also common in a case when the business is conducted under group company. As the creditors in this corporate setting are prejudiced a lot, a detailed discussion on creditor's protection accorded under the commercial code is needed for the corporate group is so much important.

4.2.4. Creditors Protection in a Corporate Group Setting

Under the Ethiopian Commercial Code, once the company acquired its legal personality,[440] it becomes a distinct legal person which can undertake various juridical activities by its own name.[441] The fact that the company is separate from its shareholders and acquire a distinct property interest will make it liable for the debts it incurs.[442]Based on the manner how the companies organized, group companies can be classified as vertically related companies and horizontally related companies. The first group of companies refers to parent-subsidiary companies in which one company holds the majority of shares in the other company or has substantial control.[443] Horizontally related companies on the other hand refer to those sister or affiliated companies which have common shareholders and who own the whole of the companies by themselves. [444]

Operating business in a Group Company by itself is not a danger for creditors but it is when the group companies are formed and used for abusive purposes that endanger creditor's rights. [445] As the corporate form of doing business by nature featured by separate legal personality, each member in a certain group company is only liable for their own debts not for the debts of the other. But business in group companies is performed by economically interrelated companies in

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[440] To acquire legal personality under the Ethiopian system, fulfilling those legal requirements embodied under article 223, 323, 324 is necessary

[441] The publication requirement did not practically exist as there is no commercial Gazette and recently the new registration and licensing proclamation (Proclamation No. 686/2010) has explicitly abrogated the requirement of publication.

[442]Supra note 44,EndalewLijalem, 'The doctrine of Piercing the Corporate Veil, p. 82

[443]*id*, p.28

[444]*Ibid*

[445]*Ibid*

which the economic interest of the whole group is pursued.[446] In such circumstances, creditors of the controlled company may not get the performance of their obligation from the company not pursuing its own interest, and due to the principle of separate legal personality; creditors could not easily go against the other member company in whose interest the debtor company was working.[447] Some of the dangers faced by creditors in Group Company are: corporate management decision is made with a view to the overall return on investment than the profitability of a particular unit, artificial allocation of property among the constituent company, and inadequate initial capitalization.[448] To protect such danger directed against creditors, the laws of different country try to come up with different policy choices. [449]Ethiopia, unlike those civil law countries, has no special regime to regulate corporate group. Currently, those rules which regulate corporate group companies are scattered here and there in a different body of law including bankruptcy law, financial market regulation laws, and commercial code.

All in all, many commentators agreed on the point that corporate groups are poorly regulated both in financial and non-financial laws. As the main focus of this paper is on non-financial share companies, it would be good to entertain some of the provisions indicated under the Commercial Code of Ethiopia which mainly concerns the protection of creditors. Among those acts of the grouping, cross-holding is the one that is regulated under Article 344 of the Code. Cross holding has been already discussed, no need to spend time to entertain this issue. The other important provision which regulates Group Company under the Commercial Code is the provision which requires group companies to have a consolidated account. The rationale behind for requiring such consolidated account is to create a true picture of their financial position and to convey information for minority and creditor as to the overall operation of a business,

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[446]MehamedAliyeWaritu, *Affiliate companies in Ethiopia: Analysis of Organization, Legal Frame Work and The Current practice*, LLB Thesis, AAU, law faculty, 2010[Unpublished, available at Law library], p. 26(here in afterMehamedAliye*Affiliate companies in Ethiopia*), p. 26

[447]*ibid*

[448]*id*, p. 27

[449] Among those the one which is relied on by most civil law countries is statutory regulation in which special bodies of rules are designed to deal with corporate groups.[449] In the common law countries, this statutory regulation is unknown rather corporate group is subject to the judicial practice of piercing the veil doctrine by making an exception to the principle of legal personality. see MehamedAliyeWaritu, *Affiliate companies in Ethiopia,* p. 27

management, and performance of the group[450]. With this motive behind, the Commercial Code provides that if the company is holding or parent company, the account of its subsidiary needs to be submitted to the annual general meeting with its own at the same time and manner. [451]

The other rule which involve corporate group is as discussed earlier in a case when the bodies corporate appointed as director of the company.[452] This is the case when the parent company subscribes to the shares of the other. As a director of the company, the parent company has got a duty and liability as it is evident from the reading article 362-367 of the code. Based on that, the veil of limited liability of the parent company can be pierced and creditor of the subsidiary company can proceed against the parent company which acts as the director of their debtor in a case when it fails to preserve the intact of the capital of the subsidy company according to art 366 of the code.[453] In the same fashion, the parent company's veil is also pierced in a case when the subsidiary company declared bankrupt under art 1160 of the com code. The problemHowever under the Ethiopian legal system is the parent company could be liable only where it acts as a director. Beyond that, there is no provision under the commercial code of Ethiopia which regulates to pierce the veil of sister companies to make liable for the debt of the other sister company.

Apart from the provision of the commercial code, group companies are also governed under art 34 of the business licensing and registration proclamation. According to this provision, holding company can be established so long as it does not disturb computation. But there is a joint and several liability with its member companies to the claims of third parties. In addition to that, these group companies are duty bound to keep annual financial records other information including that of its member companies and provide access to such documentation whenever requested by relevant authority.

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[450] As one mechanism of financial reporting, consolidated account play the important role of monitoring the group company and thereby protect the interest of stakeholder including creditors, shareholder and that of the minority. Affiliate, p.55

[451]Supra note 4, Com code, art 451(1)

[452]*id*, art 347(4)

[453]*id*, art 366(1)

4.2.5. MandatoryDisclosure and TheProtection of Corporate Creditor

Gower's in his book rightly mentioned a principle which state that "Forewarned is forearmed" the fundamental principle underlining the company's Act has been that of the disclosure.[454]According to this principle, if users of the information including creditors are enabled to access all relevant information about the company, they can safeguard their rights from the company's mischiefs. Among stakeholders who are the addressees of corporate disclosure, creditors of the company come first. Due to the limited nature of liability, the corporate creditors are highly interested in the corporate aspects of the disclosure. If so, in what mechanism that the creditors need to be disclosed with such information is the next logical question. According to FekaduPetros, there are about four mechanisms to secure disclosure according to the Ethiopia commercial code and other jurisdictions. These are: by making available some documents at the office of the registrar of companies, by compulsory deposit and registration in the commercial register, by compulsory disclosure of financial position in the company's published accounts and finally by presenting documents for a shareholder in a different meeting.[455] Disclosing via published accounts and depositing documents at the official register is made to give information for those third parties including creditors who have a future dealing with the company but not limited to them.[456] But the other two are usually made for shareholders themselves though the law provides it for all. Disclosure made under our commercial code can be broadly classified into two: that is financial and non-financial.

The legal frameworks upon which the company's disclosure is governed are scattered in different law including Commercial Code, other specialty laws including Financial Reporting Proclamation No 847 including its Regulations No. 332/2015, Federal Income Tax Proclamation No 979/2016 directives, and others. As the main objective purpose of this paper is to entertain disclosure from the perspective of corporate creditor protection, the discussion will be limited to those rules disclosures that have some effects on their protection. Corporate disclosure can be financial and non-financial. Under this section, an attempt will be made to discuss both.

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[454]L.C.B Gower's, *principles of modern company law*, 5th edition, sweet and Maxwell international student edition, London, 1992, p. 447 (hereinafter B Gower's, *principles of modern company law*)
[455]FekaduPetrose, the Ethiopian company law, p.243 see also Gower, the principle of modern company law, p. 447
[456]*Id*, p. 242

4.2.5.1. Non-financial aspects of corporate disclosure

To entertain some of the provisions stipulated under the commercial code, when the companies are formed, the founders are required to prepare a prospectus for the would-be subscribers.[457] This is a kind of invitation to offer as it brings notice to the public as to the formation of a new company or the availability of shares in an existing company.[458] In sum, a prospectus is nothing but documents that set forth the nature and the object of an issue of shares, debentures, or other security being created by the company and inviting the people to issue. [459]Hence, the Commercial Code governs the issuance of a prospectus under Article 318 and 434. Then this is the one and the first way to disclose the company's formation to the general public including creditors as to the issuance of debentures. At this juncture it is good to underline that, thepublicissuanceof debenturesis in thesamewayas it regulates the issuance of shares through the public subscription methodAs can be understood from the reading of Article 318, the information provided under the prospectus is limited to convey the draft memorandum of association, article of association, summary of expert's report on the valuation of in-kind contribution, and some other procedural information. Unlike this, when a company offers new shares or debentures to the public subscription, the information provided under the prospectus is somewhat detail as the company is already formed.[460].

The other informative document which helps the creditor to know about the debtor company is the memorandum of association. A memorandum of association is a constitution of a company upon which the basic structure of the company is designated. Furthermore, as being a public document, it governs the relationship between the company and third-party outsiders.[461]That is why the commercial code stipulates a memorandum of association to be filed with the commercial register at the time when the company formed and thereby the third-party including creditor can access. As one can understand from the reading of Article 313 of the Commercial Code, a lot of basic information that is necessary for the establishment of corporate business is provided. Among them, information regarding the business purpose of the company is basic

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[457]*Supranote* 4, Com code, art 318
[458]*id*, art 469
[459] Black's law dictionary, 8[th]ed, "prospectus"
[460]*Supranote* 4, Com code, art 469
[461]*Supranote* 6, Nega and Ermiase, *law of trader and business organization*, p. 84

information for creditor's protection. This is precisely because if the business purposes of the company are indicated, the creditor will be in a better position to decide whether to transact with a company or not.[462] The other important information to be stated in the memorandum of association is the amount of capital subscribed and paid up.[463] As the capital of the company is security for creditor's repayment, information regarding to it is important to make an informed decision. Other important information contained under the memorandum of association which is especially relevant for creditor protection is a clause regard contribution in kind, the manner of distributing profit, how the company issues its report. As the memorandum of association, the prospectus is required to be filed in the commercial register as per Article 323 and the creditor can access those pubic documents.

4.2.5.2. Financial Corporate disclosure

At the price of limited liability, the maximum possible disclosure of information regarding the company's financial position should be made.[464] As it is well explained in some literature, the basic objective of corporate finical reporting for the creditor is providing basic information that enables them to make a sound investment decision.[465] Beyond that, creditors will be benefited from annual reports made by the company as it helps to know the result of the business activity of a firm including its credibility and reliability of the business.[466] This protection of creditors through the instrumentality of disclosure can be achieved by a well-crafted legal framework that prescribes the measurement, recognition, presentation, and disclosure of information in the annual reports; the books to be kept, and the types of financial statements to be prepared.[467] Not only this, but it is also necessary to have a regulatory institution that can watch the compliance with the legal framework which is independent and professional who can give assurance on the quality information disclosed on the annual report of the company.[468] Hence, the Ethiopia Accounting and Auditing Board has been established as the regulatory institution for financial reporting by the Council of Ministers Regulation No. 332/2014 following Proclamation No.

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[462] *ibid*
[463] Com code, art 313(5)
[464] *Supranote* 454, Gower, *the modern principle of company law*, p. 45
[465] Supra note 185, Teferi, 'Corporate Financial Reporting Legal and Regulatory Frameworks in Ethiopia, p. 57
[466] *ibid*
[467] *ibid*
[468] *id*, p. 58

847/2014. To entertain the issue of financial corporate disclosure, scrutiny of the provision of the Commercial Code and financial reporting pro no 847

Under the Commercial Code of Ethiopia, the companies are required to prepare some types of financial statements. The first rule which deals with accounts and annual reports is Article 446 of Commercial Code which mandates the director to prepare a balance sheet and profit and loss accounts. Not only this, but they are also responsible to prepare reports which contain detail information on these above mentioned financial reports to the general meeting.[469] In addition to that, reports are also needed to be prepared about the exact statement of the total amount of remuneration of the director and auditors and proposal for the distribution of dividends.[470] To assure the comparability of accounting reports, the law specifically provides that these financial reports should be prepared in the same form as in preceding years.[471] Not only this, in case when there are in-kind contributions the method of valuation that should be followed needs to be the same unless the general meeting provides otherwise on the reasoned advice. [472] This is especially important for creditors to make a comparison to have a true and fair view of the company's financial position. The law also tries to safeguard the creditors in a case when the companies operate a business in a group by requiring the preparation of a consolidated financial account at the same time and in the same manner.[473] This helps creditor as to have a clear picture of the overall operation of business, management, and performance of the group companies.[474]

Coming to the point of corporate disclosure for the corporate creditor, the publication of the balance sheet on the commercial gazette stipulated under art 461 is one mechanism. According to this provision, the balance sheet has to be sent to the then ministry of commerce and industry now MOTI, for publication after the approval has been made in addition to that of the relevant minute of approval. Further, it is on the official commercial gazette that the balance sheet has to be published. In addition to that of publication, creditors can access those financial accounts filed

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[469]*Supranote* 4, Com code, Cumulative reading of art 448 and art 419(1)
[470]*id*, art 446(3)
[471]*id* art 448(1)
[472]*ibid*
[473]*id*, art 451(1)
[474]*Supranote* 446, MehamedAliye, *Affiliate companies in Ethiopia*, p.55

in the ministry of commerce and industry, as it is a public institution that any interested party can request the presence of such documents.

The other important aspect of financial disclosure provided by the law is in a case when the given company reduced its capital. Accordingly, the law imposes an obligation of publication and entry to the commercial register in the case when the company's reduction of capital is effected. [475] By adopting these double disclosure requirements, the law ensures the protection of creditors. On the other hand, upon the increment of capital, the company is required to disclose a prospectus. [476] The issuances of the prospectus at this time require a kind of broader and detailed information including the financial report of last year.[477]

i. Disclosure under financial reporting proclamation no 847

Taking in to account the inability of commercial code to govern the existing financial reporting, the legislator has come up with a new proclamation to govern the overall aspects of financial reporting called "the Financial Reporting Proclamation No. 847/2014".[478]As one basic objective, the proclamation has established a body that regulates the financial reporting called the Accounting and Auditing Board of Ethiopia and entrusted with several powers under Article 4. Among the power vested to this board, issuing standard and directive relating to financial reporting, watching the observance of financial reports and auditing standards, register and license public auditors, receive and register financial statements of reporting entities, review and monitor the accuracy and fairness of financial statement to enforce compliance with the reporting standards, advise the Government on any matter relating to financial reporting, accounting, auditing, and corporate governance is the main one. [479]

This proclamation has provided the accounting standard that needs to be followed by reporting entities.[480] Accordingly, the financial reporting standards are categorized into three based on the

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[475]*Supranote* 4, Com code art 485
[476]*id*, p. 469
[477]*ibid*
[478] Financial Reporting Proclamation, 2014, *Federal Negarit Gazette*, pro no 847/2014, 20'" Year(here in after Financial Reporting Proclamation no 847)
[479]*Ibid*, art 4
[480]*Id*, Art 5, reporting entities are those entities that are required by law to report financial statement, art 2 of the Financial Reporting Proclamation

type of entities that are required to make financial reporting.[481] The first one is the financial reporting standard which is applicable to charities and societyis called international public sector accounting standards (IPSAS), international financial reporting standard for small and medium enterprises (IFRSSM), international financial reporting standard applies to include any public interest entity (IFRS).[482] Based on these standards, every reporting entity including companies is required to submit their financial statement to the board.[483]At this juncture, it is good to know the meaning given to the financial statement in the proclamation. Accordingly, the financial statement includes but not limited to balance sheet, profit and loss account, statement of change of equity, cash flow statement, and explanatory notes whether it is interim or final. As one can understand from this definition, the proclamation broadens the very meaning given to financial statements. Further, the proclamation provides that these financial statements together with the auditor's report should be submitted for registration to the board.[484] Whether proper financial reporting is made to this authority will be the question discussed later.

The proclamation further states that the financial statements need to be audited by the auditor established under Article 10 of the Proclamation. Auditors, in accomplishing their task, they need to follow the international standard for auditing which is issued by the international federation of accountants or its successor as adopted, adapted, or amended by the Board.[485] Further, they need to be licensed as public auditor by the board before they hold position or offer any service, as an auditor for public interest entities. What is more, the law also requires the auditor to be independent.[486] Accordingly, the auditors whether they are public or certified are required to carry out their function in a manner that conforms to any code of professional conduct and ethics adopted by the board.[487]

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[481]*ibid*

[482] Entities with public accountability refer those business organizations which can have more than 100 employees and annual sales 50, 000,000 and have 100, 000, 000 debt and those institutions which administer the money of the other needs to follow the IFRS. See the www. Ebstv program, April 15

[483]*Supranote* 478, Financial reporting proclamation no 847, art 8(1)

[484]*Id*, Art (1)

[485]*Id*,12 (1)

[486]*Id*, Art 33

[487]*Id* Art 33(1)

Once registration is of this financial statement is accomplished, the financial statements of the companies are open for those interested parties upon the payment of the prescribed fee.[488] This is especially important for creditors who are highly interested to know the financial position and performance of the company. When they are interested to know about the financial statement of the company, the creditors upon the proof of their interest, they will be accessible with those documents which help them to make an informed decision.

4.2.6. Debenture holder right

As it is already stated under the previous chapters, one source of finance for companies is issuing debt security called debenture. A debenture is a debt security that entitles its holder to collect interest until the debt fully paid.[489] Further, it is the usual way of raising funds from the general public. In case when the company's lenders like banks require collateral which is not affordable, demand high-interest rate which might drain the company's capital, stringent requirement to screen debts and unwillingness or inability to lend the entire amount of finance needed, the companies may be attracted to look for the issuance of a debenture.[490] That is why some commentators argue that debenture is advantageous for its lower interest rate for the debtor, for the availability of a high volume of loan and the time for repayment can be determined by investors.[491] Let alone this attractive features of debenture, a debenture is not used as a source of funds in Ethiopia. As far as the status of the debenture holder is concerned, they are considered as a creditor of the company who claims periodic interest or another form of privileges.[492] The manner how debentures issued may be different: i.e. it may be subscribed directly from the company or the stock exchange or underwriters.[493] Debentures may be secured or unsecured. In case when debentures are not backed by any specific or general security, they will have the status of an unsecured creditor who enjoys lesser priority to get paid.[494]

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[488]*Id*, Art 11 (4)
[489]AneboLantera .'Debenture as Alternate Scheme of Raising Investment Fund and Its Prospects under Ethiopian Company Law', *Mizan Law Review*, Vol.133 No. 3, pp. 333-362, 2019, p. 338 (hereinafterAnebo, Lantera 'Debenture as Alternate Scheme of Raising Investment Fund)
[490]*Ibid*
[491]*id*, p. 335
[492]*ibid*
[493]*id*, p. 341
[494]*id*, p.343

Concerning its naming, debenture and bond are the two most confusing words but connote different meanings. Their difference lies in whether they have secured obligation or not. Some take the word bonds as a secured kind of obligation while debenture is an unsecured one.[495] But sometimes an obligation which is not secured but issued by the government or institutions having government affiliation may be regarded as a bond.[496] On the other hand, some consider bond as a secured type of debt while debenture as a type of bond which is not secured.[497]

Coming to the case of Ethiopia, the commercial code has provided some provisions which govern the issuance of the debenture and the right of the holder under its chapter five from Article 429-444 of the Commercial Code. As can be evidenced from the reading of these provisions, the Code has failed to define bond or debenture. But Amharic version uses the same designation called "*yegedetaworktoche*). From such one might argue that the two terms are synonyms as far as the commercial code is concerned though it consistently employs the word debenture except for the term bond under art 432.[498]

Under the Ethiopia com code, it is the share company that cans issues debentures. This is because, for one thing, the provision of the commercial code which deals with debenture is found under the share company section. For the other reason, a business organization like a joint venture and PLC are generally prohibited from issuing transferable securities.[499] Besides, the law under Article 429 prohibits individuals from issuing debentures. This is to protect the general public which lends the money by the instrumentality of transferable security including debenture.

To issue debenture under the Ethiopia commercial code, some requirements should be fulfilled. Accordingly, the law under Article 429 of the Code provides a kind of negative requirement, those cases by which debentures cannot be issued by the companies whose capital is not fully paid, and which is not issued a balance sheet in respect of their first financial year.[500] Starting

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[495]*id*, p.344
[496]*ibid*
[497]*ibid*
[498]*Supranote6*, Ermias and Nega, *the law of trader and business organization*, p. 126
[499]*Supranote* 4, Com code, 510(3) & 274. But still one can argue that the three types of partnerships such as general, ordinary, and limited can issue debenture as they are not clearly prohibited.
[500] Com code, art 429

from the first requirement to issue debenture is the company's capital should be fully paid. As the company's capital is the only guarantee for the repayment of creditors, first, the subscribed capital should be fully paid. The rationale behind such stipulations seems that the company needs to exhaust the possibility of finance under its hand.[501] The second requirement is the company should issue a balance sheet of its first financial year. By this requirement, the law tries to ensure the financial worthiness of the company. As the balance sheet indicates the current company's asset, debt, and capital, a close observance can be made of the actual company's financial position.

As we can understand from this requirement, the company cannot issue debenture at its formation stage as it requires the issuance of the balance sheet which is done on the annual basis.[502] The third requirement to issue debenture under the Commercial Code is the issuance of debenture has to be approved by an ordinary general meeting.[503] This is amongst the requirements that are done to protect the debenture holder. The last but not the least requirement is the maximum amount of debenture issued may not exceed the amount of paid-up capital. Accordingly, debentures issued by the company may not exceed the number of accounts of paid-up capital adopted in the balance sheet save some exceptional ground provided.[504] By doing so, the law takes a protective measure for creditors by limiting the company's freedom for issuing any amount debenture. The rationale behind such stipulation is to protect the capital of the company as excess issuance of debenture calls for default payment for debenture holders. By requiring the company to have a fully paid-up capital and to issue debenture in line with the amount paid-up, the law tries to safeguard bondholders from speculative risk.

The debenture holders to protect their right, they may be combined themselves as legal personality. [505] Hence, a meeting of debenture holders may be called to adopt a resolution to protect the interest of debenture holders such as, to enforce loan agreement, and to provide for all

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[501]*Supranote* 6, Ermias and Nega, *the law of trader and business*, p.126
[502]*Supranote* 489, Anebo, Lantera ‘Debenture as Alternate Scheme of Raising Investment Fund, p.349
[503] Com code, art 419(2)
[504]*Id*, art 430 According to o this provision the law allowed to issue debenture beyond the amount of paid-up capital in the case when there is an immovable property which is mortgaged and when the excess over the paid-up capital is guaranteed
[505]*id*, art 435

necessary expenses in connection therewith.[506] Not only this, but the law also gives a right for debenture holders to consider the proposal of the debtor company relating to modification in the structure of the company, amalgamation with another company, and issue of debenture having priority over the existing. [507] However, these rights of debenture holders are limited so long as the company redeems debentures within three months from such a proposal has become effective. [508] The meeting of debenture holders is also given the power to consider proposals related to variation relating to the terms of loans.[509]

4.2.7. Creditors protection inLiquidation andCorporate Reorganization

Corporate creditors are also protected in a case when the company is liquidated or dissolved. Accordingly, the commercial code stipulates that in the course of liquidation the liquidator's primary obligation is asserting the liability of the company.[510] Upon their liquidation, if there is liability or debt on the part of the company, the liquidator is prohibited from distributing the asset of the company to the shareholder until the creditor of the company has been fully paid.[511]To effectively enforce this right, the creditor should be promptly informed as to the dissolution of the company and to file their claims.[512]The law has also provided the mechanism to notify the creditor under art 502 of the code. For those creditors who cannot appear and file their claims, the amount owing to them shall be paid to the court.[513] As a resultof this, one can safely say that the right of creditor is protected even at their default. So that, a shareholder may not be benefited from the nonappearance of the creditors as it is after the satisfaction of the creditor claims that the surplus asset (if any) may be distributed to the shareholder.[514] Such distribution of asset may not be made until one year from the third publication to notify creditor lapses.[515]Until the lapse of such a period, the distribution may be suspended unless it is satisfied that the creditor will not suffer. Beyond all, the law has also up come with a kind protective

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[506]*id*, art 437
[507]*id*, art 438
[508]*id*, art 438(2)
[509]*id*, art 438(3)
[510]*id*, art 499(3)
[511]*id*, art 501
[512] *Id*, Art 502(2)
[513]*Id*, art 503(1)
[514]*Id*, art 504
[515]*id*, art 505

mechanism for those creditors who comes after striking off the commercial register i.e. the creditor can ask individual shareholders in person to the extent of their shares in the surplus asset.[516]

Regarding the rights of corporate creditors during a corporate reorganization, the commercial code tries to safeguard their rights both at the time of merger and conversion. A merger with another company may increase the probability of risk to the creditor. Accordingly, the creditors may object to such kind of reorganization if it is going against their interest.[517]As it is already stated above, in the decision of amalgamation, the meeting of debenture holders is even required to approve.[518]However, the code does not specify as to the very effect of creditor's objection towards the merger. Besides,in the conversion of the company to the other form of the company say for instance from Share Company to PLC, the creditors of the former business organization retain all their rights, as regards the new business organization. They may also object and demand their debt be paid before the conversion takes place.[519]

Part Two

4. 3. Inadequacy of the Ethiopian share company law in providing effective protection for corporate creditors

Under this part of the paper, an attempt will be made to access the adequacy of the Ethiopia share company law in light of internationally accepted principles such as the OECD principle on corporate governance and the doctrine of capital maintenance rules.

4.3.1 Poor corporate disclosure

Before directly proceed to the analyses of Ethiopian share company law, it is better to have insight about the OECD principle of corporate governance regarding to the issue of corporate disclosure and transparency as it based on this internationally accepted principle that our law tested.

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[516]*id* , art 508
[517]*id* art 552
[518]*Id*, art 550
[519]*id* art 546

4.3.1.1 Corporate Disclosure under the OECD Principles of Corporate Governance

As the adequacy of Ethiopian shares company law governing corporate disclosure assessed in light of the OECD principle of corporate governance, it is necessary to understand the principle against which the Ethiopia law tested. Among the principles of OECD, it is principle IV and V which mainly concerns the role of stakeholders in corporate governance, and disclosure and transparency will be used to access the Ethiopian share company law.

The fourth principle of the OECD provides that, the corporate governance framework should address the rights of stakeholders stipulated by law or through a contractual agreement. Further, the principle has also provided that corporate governance should encourage the active cooperation between the company and the stakeholders to create wealth, jobs, and sustainability of financially sound enterprises. [520] More specifically, this OECD principle urges that when the stakeholders including creditors participate in the corporate governance process, they should be accessible with information that is relevant, sufficient, timely, and reliable. [521] By doing that, the principle recognizes the interest of stakeholders including creditors, and their important contribution to the long-term success of the company. [522]Hence, the principle has this objective of ensuring the flow of external capital to companies in the form of credit and thereby lowering the cost of capital for the company.

As it has been stated repeatedly, creditors are among stakeholders who are the main beneficiary of mandatory disclosure as it enables them to make an informed decision to determine whether they transact with the company or not.In corporate governance practice, it is evident that those companies which have good corporate governance records are often able to borrow a sufficient amount of money to fund their projects in more favorable terms unlike that of the companies with poor records of corporate governance and non-transparent markets. [523] On the other hand, if there is insufficient or unclearinformation, it may hamper the ability of the markets to function, increase thecost of capital and result in a poor allocation of resources.[524]

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[520]Supra note 233, OECD principle IV
[521]*id*, principle IV
[522]*id*, annotation, p. 46
[523] OECD principle 5, p. 48
[524]*ibid*

The other OECD principle which specifically enshrined the issue of corporate disclosure and transparency in detail fashion is principle five. This principle states that "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company."As one can understand from the reading of the above-mentioned principle, the subjects of disclosure that the company needs to make are the financial situation, performance, ownership, and governance of the company. To determine the type of information that needs to be disclosed to the minimum, the concept of materiality has been used in many countries.[525] Accordingly, if the omission or misstatements of the information influence the economic decision of the user of the information including shareholders, creditors, the information is said to be material and needs to be disclosed. [526]

Regarding the disclosure of the financial situation of the company, the OECD principle has made clear that the financial performance of the company can be indicated by those financial statements. The most common type of financial statement which serves as an important source of information on companies includes but is not limited to balance sheet, profit and loss statement, cash flow statement, and notes to the financial statement. [527]Having said this let me see the types of information on the company's subject to disclosure. As provided in this principle, there are two principal goals of financial statements. These are, to enable appropriate monitoring of the management as well as the directors of the company. The manner how this financial information is disclosed,and the type of financial information disclosed has a lot to do with the protection of creditors. This is because creditors who lend or advance credit needs to be benefited from having reliable financial information relating to the company.

Concerning the type of financial information that is important for creditor's protection, the above-cited types of financial statement which is a balance sheet, profit and loss statement, cash flow statement and notes to the financial statement are relevant as it enables creditors to determine the creditworthiness of debtor periodically. Regarding the manner how these financial statements need to be prepared, the OECD principle has underlined that the financial statement

[525]*ibid*
[526]*ibid*
[527]*ibid*

should be prepared and disclosed with high quality internationally recognized standards of accounting and financial and non-financial. [528] Related to this, the principle has also further state that the annual audit should be conducted by an independent, competent and qualified, auditor to provide an external and objective assurance and to fairly represent the financial position and performance of the company in all material respects.

The other important pillar of disclosure is information related to the major shareholding of the shares. Accordingly, the investor has the right to be informed about the ownership structure of the company. [529]In such disclosure, information regarding major shareholding extends to the disclosure of information about the structure of a group of companies and intragroup relations. Accordingly, disclosure regarding group companies should indicate the objectives, nature, and structure of the group.[530] Most importantly, counties often so require the disclosure of ownership data once a certain threshold of ownership are passed. [531] This includes the disclosure of the data on major shareholding that may result in the control of the company either directly or indirectly including special voting rights, ownership of controlling or large blocks of shares, significant cross-shareholding relationship, and cross guarantee.[532] At this juncture, it is clear that the major shareholding of companies expressed through the instrumentality of significant cross-shareholding is among the particulars of disclosure that helps corporate creditors as it affects the company's capital that the creditors are looking for. That is why the law of different counties tries to govern the joint holding of share beyond a certain threshold in most cases beyond 10 % of the company's capital by imposing disclosure obligation or by providing a cap.

4.3.1.2. The inadequacy of the Ethiopia share company law in light of the standards of OECD Principles in providing effective protection for corporate creditors

As the very objective of this paper in this section is to demonstrate the Ethiopia share company law in light of the OECD principle of corporate governance, analyses of the law will be made on the issues like, financial reporting requirements as enshrined under the commercial code and

[528]Supra note 233, OECD principle 5(b)
[529] OECD principle 5
[530]*ibid*
[531]*ibid*
[532]*ibid*

proclamation no 847 of the financial reporting proclamation, the disclosure of some other information which implies creditors protection and the effective application of these laws concerning the above-cited disclose requirement will be discussed. Thus, analyses under this chapter identify the legal loopholes and drawbacks of the Ethiopian share company law with the above-cited OECD principle of corporate governance.

I. Non-observance of financial reporting

Generally speaking, some of the defects of the Commercial Code of Ethiopia regarding financial reporting are addressed by the Financial Reporting Proclamation No 847/2014. Among those, mention can be made unlike that of the commercial code which requires the preparation of only balance sheet and profit and loss account,[533] this proclamation widens the required financial statement that needs to be prepared and submitted for AABE. These include a statement of change in equity, cash flow statement,[534] comparative of this financial statement and explanatory notes. [535]Besides, the proclamation has also rectified the hitches of the commercial code by providing international accounting and auditing standards. The commercial code, even if it mandates the director to prepare the financial statements, failed to specify the standard upon which this financial statement is prepared and audited. Accordingly, three standards of accounting are adopted by the proclamation. These are international financial reporting standards (IFRS), international reporting standards for small and medium enterprises (IFRSSM) international Public Sector Accounting standards applicable to charities and societies. (IFRSCS). Further, according to Mr. WerkuAlemu,[536]these three standards accountings are called general-purpose financial standards as it is helpful for those stakeholders including creditors who has no bargaining power to request the from the company.[537]This is especially true for trade creditors

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[533]Supra note 4, Commercial Code, Art 446(2

[534] From the perspective of the protection of creditors, financial statements like cash flow statement are important as it enables them to define the solvency of the company by making cash forecasts. As such, creditors will be interested in knowing the fact that the company will be able to pay its debts as they become due. Accordingly, omitting the cash flow statement from the financial reporting requirement has its own negative consequences on the protection of corporate creditors. Hence the use of this cash flow analysis is important in appreciating the company's accounting records to measure the company's liquidity or its ability to make short-term payment.

[535] Interview with WerkuAlmu, Director of education and training of the accounting and auditing board of Ethiopia (AABE), on *the issue of corporate disclosure*, September 30, 2020. See art 2(8) of the financial reporting proclamation. (here inafter Interview with WerkuAlemu, director of education and training at AABE)

[536]*ibid*

[537]*ibid*

and employees who cannot negotiate terms with the company.[538] Besides, the proclamation has also rectified the commercial code's failures in providing auditing standards qualifications of auditors. Accordingly, auditing standards to be used by auditors in Ethiopia is the intentional standard for auditing issued by the international federation of accountants or is a successor as adopted or amended by the board.[539]

the commercial code under Article 419, 446, 447, and 448 mandate the director of the company to disclose such financial statements to shareholders. However, as it is evident from the reading of the above cited commercial code provisions, there is no way by which the creditors of the company can access the financial statements of the company as nothing indicates in the code this will be part of the entry in the commercial register or will be accessible to the creditors. They are only limited to the shareholders of the company. This means that the commercial code does not stipulate the direct accessibility of the financial statement to the creditors. The only way by which the creditors can seek the disclosure of the information is when these financial statements are sent to the ministery of commerce and industry and upon the publication of the balance sheet per art 461. Unfortunately, the official commercial gazzeta in which the commercial code refers is not established in the country. Further, there is no attempt to publish such a balance sheet of the company by a widely circulated newspaper in Ethiopia.[540] If that so, there is no mechanism by which the creditors of the company can access such financial statements so as to know the financial performance and situation of the company unless there are terms of contract which oblige periodical disclosure of the financial statements. Even though, the financial reporting proclamation has averted the failures of the code by making the financial statements of the company to be accessible on the board for those third parties who wish to investigate upon the proof of their interest.[541] However, the board's accessibility by itself is limited to Addis Ababa. For instance, one can see the board's news from its website which indicates the call for submission of the financial statements of the reporting entity to the board from only Addis Ababa.[542]

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[538]*ibid*

[539] Financial reporting proclamation no 847, Art 12(1)

[540]*Supranote* 540, Interview with HenokeHailu, on *the issue of corporate disclosure,* September 28, 2020.

[541]*Supranote* 478, Financial reporting proclamation, Article 11(4)

[542] www.Aabegov.et. last accessed on 15-Oct-2020

Legally speaking, the financial reporting proclamation has come with those contemporary accounting and auditing standards together with sophisticated financial reporting. By providing that, it tries to enhance corporate disclosure and transparency of Ethiopia consistent with the OECD principle of corporate governance and international good practice. Though the law tries to advance itself to this extent, still there is a practical hindrance. Here are some of the practical hindrances of the board AABE.

1. Even though the law mandate all the reporting entity to adopt the IFRS and submit financial reports, practically, it is not all the reporting entities including share companies are implementing IFRS and they are not still under a duty to report those financial statements to the board per the proclamation. [543] Currently, most public enterprises, banks, and insurance companies are adopting IFRS accounting standards.Coming into the non-financial company's financial reporting practice, currently, they are not in a position to adopts such accounting standards. This is triggred by the reasons like, lack of awareness, lack of capacity to implement these internationally accepted accounting standards, simple disregard, lack of experts to implement the IFRS, lack of positive outlook for standards.[544] Accordingly, the creditors of the companies can not avail themselves of these financial statements which helps them to appreciate the financial position of the company. To implement this law and accounting standard, the office tries to adopt a new road map for those institutions which cannot adopt these reporting standards. Besides, the office is also trying to create awareness via different mechanisms.[545]
2. The other practical problems involving this proclamation are though the proclamation under art 11(4) enables an interested third party to access those submitted financial reports, the financial statements required to be submitted by their nature are technical and need to clarify by a professional accountant. But there is no such trend of explaining the implication of these financial statements for those third parties who appear before the board.[546] If that so, how creditors and other third parties who want to access these financial

[543]Supra note 535, Interview with WerkuAlmu,*on the issue of corporate disclosure,*
[544]*ibid*
[545]*ibid*
[546]*ibid*

statements can easily understand such financial statements. This creat a practical hindrance for creditors as the board failed to provide such services.

ii. Disclosure other than financial reports

Let alone the financial reporting standards, the commercial code is also failed to provide adequate disclosure for the protection of corporate creditors for the following specific reasons.

1. To control any attempt to the reduction of capital and thereby prejudice the interest of corporate creditors, the law under art 484 mandates the publication requirement before the reduction is effected. According to this provision, when the capital of the company is reduced, entry should be made to the commercial register and to be published in the commercial Gazzetta. However, there is no such requirement in the business registration and licensing institution that is in charge of this responsibility.[547] According to Eregessa Gonfa, the supervisor of business registration and licensing, there is no such requirement of registering the reduction of capital in the said institution and there is no mechanism to enforce such requirements of the law.[548] He further states that the only way to cross-check whether a given company is reducing its capital or not is in the time when the renewal of the business license. In such circumstances when the company's capital is reduced below ¼ of the capital, the company is required to inject fresh funds or required to start the process of liquidation.[549]Furthr more, the reduction of the capital is one instance which necessitate the amendement of the memorandom of assciation. But practically, there is no such trend of amending the memorandom of assicaition in case when the company reduce its capital. [550]
2. The second issue of disclosure has related the disclosure of the majority of shareholding of companies among which the one is cross-holding delt under art 344 of the com code. This provision governs the joint holding of shares between two companies beyond 10 % of their capital. As the joint holding of the capital by companies has a potential effect on the capital of the company, the law failed to incorporate a provision that notifies the creditors as to the existence of such cross-holding. Due to the omission of this disclosure requirement, the creditors are not protected from such mischiefs which may arise from the cross-holding of

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[547] Interview withEregessaGonfa , supervisor of business licensing and registration at MOT, *on the issue of corporate disclosure*, September 29, 2020
[548]*ibid*
[549]*ibid*
[550]*Ibid*

the company. Further, it is not in line with the OECD principle which tries to regulate major shareholding which is above a certain threshold.

3. The other point of the commercial code failure is regarding the publication of the balance sheet of the company provided under the art 461 of the com code. According to this provision, the law after the approval of the balance sheet by the ordinary meeting obliges the directors of the company to send to the ministry of commerce and industry for publication in the official commercial Gazzetta. But practically, there is no such trend of publishing balance sheets at all.[551] This is due to the reason why in the first place as been said earlier there is no official commercial Gazzetta established in the country, secondly, there is no such trend of publishing balance sheet even by most circulated newspaper. [552]In addition, the law under this provision failed to provide the effect of non-observance of publication requirement. In the net shell, the absence of such publication of balance sheet has a negative impact on their disclosure right as they cannot access the financial situation of the company through the instrumentality of the publication and thereby cannot make informed decisions which safeguard their right.
4. The other concern concerning the disclosure rights of a corporate creditor is related to the issuance of the prospectus. Regarding the scope and the content of information required to be disclosed via the prospectus, jurisdiction differs in their commitment to disclose. [553] Among that important information, the one is which is called benchmark data, which is the disclosure of information regarding the basic description of the company including the accurate statements of the company's current financial positionevidenced from its financial statements as the one and the most important. [554] Under the commercial code of Ethiopia, the issuance of the prospectus is regulated under art 318 and 469. As it is evident from the reading of this information, one can safely say that the issuance of such prospectus is not in line with the OECD principle of corporate governance. This is because, as it is clear from the cumulative reading of art 469 and 434, when the company issues debt security or denture, it needs to

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[551] Supra note 540, Interview with HenokeHailu,,on *the issue cross-holding,* September 28, 2020.
[552]*ibid*
[553]Gizachewseleshi, *corporate governance lecture note*, Bahirdar university, 2019, p. 266(here in after Gizachewseleshi, *corporate governance lecture note*)
[554]*ibid*

show the content included under art 469. According to this provision, that financial information that needs to be indicated in the prospectus are the existing amount and composition of the capital, the last profit and loss account, balance sheet and auditors' report, dividends paid during the last five years or since formation and debenture loans issued are some of them.[555] But this provision failed to require the financial statements to be prepared according to accepted international accounting and auditing standards. Not only this, but this provision is also failed to incorporate the liability of the issuer if the prospectus contains untrue or misleading statement. What is more, the law also do not provide for prior registration of the prospectus in the commercial registry Due to that, debenture holders cannot investigate the true and fair view of the financial position of the company to make sound investment decisions due to the absence such as accounting and auditing standards.

4.3.2. Inadequacy of legal capital rules under Ethiopian share company law

Under this section of the paper, an attempt will be made to access the adequacy of the Ethiopian share company law in light of the principle of legal capital rules. As has been discussed in the proceeding chapter of this paper, there are three possible ways by to use the concept of the legal capital rule to protect corporate creditors. The first one is by setting or prescribing minimum capital requirement, second restricting on payment out to shares also known as capital maintenance rule and thirdly triggering actions that must be taken following serious depletion of capital in the near insolvency.[556] As all the theoretical foundation has already dealt with in chapter three of this paper, the discussion under this section will be limited to the failure of Ethiopia to share company law in providing adequate protection for creditors.

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[555] Supra note 4, Com code, art 469

[556] Supra note 2, ReinierKraakman et al, *Anatomy of corporate law*, p. 124 see also the anatomy of corporate law, 2004 ed, p.83, 2004

4.3.2.1. Minimum capital requirement, does it provide real protection for corporate creditors?

According to Article 306 of the Commercial Code, Share Company cannot commence business until it has satisfied the registrar nominal value shares which are 50.000 Ethiopian birr.[557] Can providing minimum capital requirement confer any real protection for creditors, if it protects creditors can we say the existing amount of minimum capital is sufficient enough to provide adequate protection? In terms of its acceptance, the minimum capital requirement nowadays is taken as an outdated concept, and thereby many jurisdictions try to abolish from statutory regulation of the company.[558]

Pragmatically speaking, the Ethiopia share company law which tries to set out the minimum capital requirement has no relevance for corporate creditor protection. This is because, in the first place, the amount stated under Article 306 is very insignificant. It is surprising why the new draft commercial code doesn't amend this amount at least to coup up with the existing reality.[559] This is because of 50, 000 Ethiopia Birr in the current monetary value, it didn't serve even to complete the formation stage of the share company. If the amount is this low, it doesn't protect creditors if the company undergoes any financial distress. Secondly and most importantly, in Ethiopia, soon after the incorporation of the company this minimum amount of capital can be withdrawn.[560] This is to mean, it up to the accomplishment of the overall process of incorporation that this minimum capital is required to be deposited in a block account. If that is the case, how this minimum capital requirement couldprovide for the potential creditors. Thirdly, this minimum amount of capital will be ineffective in the case when all the debtors appear at the same time.[561] Last, but not least, justification might be whether or not there is a minimum capital requirement;

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[557] This minimum capital requirement is 184% of income per capita. See. Why are minimum capital requirements a concern for entrepreneurs, by ValentinaSaltane and Paula Garcia Serna, available at, https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB14

[558] Of the 189 economies studied in Doing Business 2014, 99 have no minimum capital requirements. Some economies never required firms to deposit money for incorporation, while 39 have eliminated minimum capital requirements in the past seven years. See Why are minimum capital requirements a concern for entrepreneurs, by ValentinaSaltane and Paula Garcia Serna, available at: https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB14-Chapters/DB14-Why-are-minimum-capital-requirements.pdf

[559] See art 247 of the draft commercial code

[560]Supra note 547, interview with Erregesa, o*n the issue of minimum capital requirement, on September 28.2020*

[561] Interview with professorTelahunTeshome, Addis Abeba University Instructor, on *the issue of minimum capital requirement,* September 29, 2020.

most entrepreneurs who wish to form Share Company appear to invest some capital even in the absence of such minimum provided capital in the statute. What is more, as most of the time the amount paid as minimum capital requirement fixed, it doesn't take in to account the company's economic activities, size or any associated risk related to their activity. As Professor Telahun rightly mentioned, this requirement is merely symbolic. Even if it believed to set a minimum capital, difficulties will arise in quantifying the amount as most of the time there is no meaningful relationship between the riskiness of the businesses and the amount of minimum capital. If so, by any amount chosen, it will be difficult to determine the ex-ante amount of uniform capital to cover the future liabilities in companies operating in different lines of businesses. Finally, this minimum capital requirement does not consider the time value of the money.[562] This is because through the business years, the value of money diminished from time to time due to inflation and other related problems.

4.3.2.2. The doctrine of capital maintenance and its observance

Under this section of the paper, an attempt will be to scrutinize those relevant provisions of the Ethiopian share company's law of Ethiopia in light of the modern company law principle called the doctrine of capital maintenance. All the theoretical foundation of this principle has been dealt with under the previous chapter. Whether the Ethiopian share company law is designed in a way to maintain the capital of the company and thereby protect corporate creditors will be the question that will be addressed in this section. In addressing such question, a specific reference will be made on those issues of cross-holding, claiming back unlawfully distributed dividend, and valuation of in-kind contribution.

I. Under regulation of Cross holding in Ethiopia share company law

As joint holding calls for the depletion of the capital of the company, a legal system should adopt well sophisticated legal rules to maintain capital. Among stakeholders who will be placed in a detrimental position as a result of poor regulation of cross-holding, corporate creditors come first. As has been dealt with earlier, cross-holding or joint holding is governed under Article 344 of the Commercial Code. Cross holding is prohibited in the case when 10 % or more of one company's capital is held by a second company, the first company cannot hold shares in the

[562] Interview with MesefenTaffese attorney at law, on *the issue minimum capital requirement*, September 28,2020

second company. As it is evident from the reading of this sub-article, the situation of cross-holding is poorly regulated in the commercial code. This is because, for one thing the joint holding under the code is concerned only betweentwo companies. But in reality, cross-holding could happen in more than two companies.

The ministry of commerce and industry is, under this provision, mandated to control the overall aspects of the joint holding in the case when the holding of the share companies beyond 10%. Whether or not the ministry handles this responsibility per the law was the other question of this researcher.

As it clear from the above-cited provision of the code, the ministry is charged with the responsibility of controlling joint holding by:

1. Receiving the declaration of the joint holding of companies which is beyond 10% of capital and make sure the reduction of such holdings to a maximum of 10%;
2. In case when the companies failed to agree to reduce their holding to 10%, order the company possessing the smaller holding to dispose of that holding; and
3. Receive a sworn statement to make sure whether they have complied with the above two requirements.

As the practical inquires of the MOT indicates that the minister does not take any of such responsibility assigned to it by law.[563]According to Henoke, generally, the MOTI is not in a position to handle these responsibilities as a result of some practical problems. Among those practical problems which hinder the institution from performing its legally assigned duty, lack of skilled manpower, lack of commitment, and shortage of budgetare a prominent one. What is more appalling issome of the employees of this ministry don't know even the existence of such legal rules which mandate the MOTI to control the overall affairs of the joint holding.

As a result of this, despite the legal restriction there is no penalty for companies that are found to be involved in join holding of shares beyond 10% as there is no governmental authorities which follow the observance of the law at hand. In the first place, to control the observance of the rules on joint holding, there should be an enforcement mechanism provided under the law.[564] In the absence of such an enforcement mechanism either by reporting obligation under pain of penalty

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[563]Supra note 540, Interview with HenokeHailu, , *on the issue of cross-holding*, September 28, 2020

[564]Supra note 561, Interview with professor TelahuneTeshome, *on the issue of cross-holding*, September 30, 2020

or by any other means, why would the companies go and declare their holding? What is more, companies are not obliged to furnish to the MOTI a sworn statement which is indicated under Article 344(4) of the Code.[565] In addition, the law by itself also failed to provide the time limit in which joint holding should be disclosed to the Ministry.

Generally, those controlling responsibilities given to the MOT are practically nonexistent. In the absence of such intuitional observance, one can easily imagine the malpractice of joint holding. As such, the objective that the legislator intended to achieve by controlling cross-holding i.e. protecting the capital of the company from envisioning is, after all, cannot be achieved. Surprisingly, the draft commercial code in which we hope to have an important revision failed to address the whole issue of cross-holding.

II. Problems related to the valuation of in-kind contribution

Company law device a mechanism that takes particular care to ensure that a contribution by a shareholder in a given share company does not jeopardize the interest of stakeholders in general and creditor's in particular. In this regard, a question like what mechanism of valuation ensures the true value of the in-kind contribution is an important question that is expected to be addressed by company laws. As it has been stated somewhere in the paper, valuation of in-kind contribution should be made by experts appointed by the MOTI and the member who contributes in kind is required to file a report made and sworn by these experts.[566] However, the newly enacted proclamation on business licensing and registration No 980/2016 provides that it is based on the agreement of founders or members of the business organization that the valuation of contribution in kind should be made.[567] According to this proclamation, the valuation is made by shareholders themselves.[568] One can simply imagine how this valuation could be fairly accomplished in the absence of 3rd party involvement. This calls the risk of overvaluation that the provision of the commercial code intended to prevent by engaging experts appointed by the MOTI.

Regarding this issue, Professor Escara, the drafter of the commercial code, states that

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[565]Supra note 540, Interview with HenokeHailu, , *on the issue of cross-holding*, September 28, 2020

[566]Supra note 4, Com code, article 315(1)

[567]Proc No 980/2016, Commercial registration and Business Licensing, art 5(9)

[568]Supra note 412, FekaduPeterose, Ethiopian company law, p. 105

> The question of the valuation of contribution in kind is one of the most delicate problems related to sharing companies. Overestimation of these contributions means that the capital no longer corresponds with the real value of the assets and from the time of formation i.e. Company is subject to an action to nullify the contribution in kind. The solution set out in article 315 is borrowed in part from the Italian civil code it is one of the most simple and effective solutions."[569]

As it is clear from this *ex-pose de motif* of the commercial code, what is dangerous especially for creditors in the case when there is in-kind contribution is the possibility of overvaluation which results in an imbalance between the stated amount of capital and the real value of capital. Shareholders to be accessible with a huge amount of borrowing they may intentionally inflate the value of the in-kind contribution. If there is no mechanism in the law to protect the creditors from overvaluation, how creditors especially those ordinary creditors who are not in a position to negotiate terms protect themselves from shareholders' opportunistic behavior.

In addition in case when the auditor and directors verify the valuation of in-kind contributionwithin six months from the formation of the company,if the value of the contribution is being lowered by 1/5, the law provides that the contributor may good the difference or shall withdraw from the company[570]. But the question here is especially in those companies who have such a huge capital, the difference amounted as 19 % is a considerably great amount. If so, the law should not tolerate such differences as it brings great differences beyond the level of tolerances. Taking in to account this, the draft commercialcodes reduce the level of tolerance to ten percentages. According, it is only when the verification of in-kind contribution being lowered by 10 % the contributor required to make good the difference.[571] What is more, the revaluation made by directors and auditors is allowed to bemade within six months from the formation of the company. However, within insix months, creditors could be deceived by such overvalued capital.

To the extreme, the law has no mechanism to prevent an agreement by shareholders that are made to contribute property that does not exist or does not belong to the contributing members? The law has no such mechanism to cross check. The same is true in the MOTI, as there is no

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[569] Peter Winiship Expose*, background documents of Ethiopian commercial code* , artistic printer, Addis Abeba , 1960,*demoftie*, p. 62

[570] Com code Art 315

[571] See the draft commercial code art 257(6). Let alone this difference, the draft mention the existing provision of the code

supervisory role to be played by it. The only regulatory institution that the researcher can find is in the Documents Authentication and Registration Authority. In such Authority, at the formation stage of Share Company some documents regarding to valuation of in-kind contribution is required to be filed. Among those document, the authority request the presence of relevant documents such as if the contributed property is a car, the contributor is required to bring clearance from transport authority and if it is an immovable property like house, the contributor is obliged to bring documents which assure whether it is free from any debt or not. But he question here is what if the contributed property is other than these mentioned immovable property and special movables? The law does not require the title certificate for every type of property that might be contributed. In such case, the shareholder may be incentivized to contribute a property which does not existor not belongs to the contributing member. In addition to the risk of overvaluation, the Ethiopian share company law is not adequate to protect corporate creditors for the following specific reasons. Beyond that, for defects regarding in-kind contribution, the law makes liable founder under art 309. But, the solution taken by the law under this provision is not a kind preventive approach. According to art 309 of the commercial code, founders are jointly and severally liable for the damage resulting from such valuation. Even if the founders could be liable for any problems related to the valuation of in-kind contribution, the creditors may not sufficiently satisfy their claim as the liability is on an individual basis. Experience has shown that, harmed creditors would not be in a position as their liability claims often cannot be satisfactorily enforced as a system that becomes relevant after the fact would not be effective as a preventive system. [572] There is this traditional saying in Ethiopia called *Jib keyed weshachohe,* stating the fact that once the legal system failed to device a mechanism to control overvaluation and other opportunistic behavior of shareholders, making liable founder may not produce sufficient remedy to meet the whole claims of the creditors. In any case, there is a need to adopts rules which prevent overvaluation rather than relying on post facto remedies.

The last but not the list problems of the in kind contribution is the in-kind contribution which is valued by the shareholder is difficult to manage. This is because the valuation of in-kind

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[572]Supra note 561, Interview with professor TelahuneTeshome, *on the issue of Valuation of in-kind contribution*, September 30, 2020

contribution by itself requires an expert's determination; it is not something that can be done via vote or something like that. In Share Company who has a great number of shareholders, it is difficult to handle the whole process of valuation as it is difficult to state. Besides, the question of integrity is being a great concern for creditors too.[573]

Let alone the in kind contribution and its valuation, there are also some other problems related to in kind contribution. The first one is the law is silent as to the usefulness of in kind contributionwhether it should be in line with the business purposes of the company or not. But, if there is in kind contribution which is not important to attain the business purposes of the company, it may hamper the success of the company and in turn expose creditors of the company to the greater risk than they forecast. [574]Further, it failed also to expressly prohibit the contribution of service as one type of non-cash contribution as it is a contribution which has limited importance for creditorsup on company's default.

III. Problems related to dividend distribution in Ethiopia share company law

As has been stated earlier, divided distribution rules have a lot to do with the maintenance of capital. Our commercial code has made clear that it is only from the net profit shown in the approved balance sheet that dividends can be paid to the shareholder. [575] If the dividend is not from the net profit, it will be regarded as a fictitious dividend. In case when there is a fictitious divided, there are two most common sanctions adopted in many countries. These are sanction imposed on directors and shareholders. The first one is the possibility of recovering from directors and other officers who were responsible for making the unlawful distribution.[576] Recovering from the director and other persons who declare such fictitious dividends is mostly the result of broken duties of care, diligence, and good faith.[577] In case when a director fails to act diligently, they are not only expected to bring back what they have taken rather, their liability is extended to cover creditors' claim and restore the company before loss which the company suffers as a result of unlawful distribution together with criminal liability. In line with that, the

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[573] Interview with TelahuneTeshome, an instructor at Addis Abeba university, *on the issue of, Valuation of in-kind contribution*, September 30, 2020

[574]Supra note 371, Seyume, on the formation of share company, p. 112

[575]*id*, art 458(1)

[576]Supra note 456, Gower, *the principle of modern company* law, p. 259

[577]*ibid*

commercial code under art 458(2) makes the director who makes such distribution will be liable both civilly and criminally. The problem of this sanction is that it is unlikely that the action will be taken against them by the company unless there is a change in those controlling the company or unless it goes into liquidations. [578]The second one is, claiming back the unlawfully distributed dividend from those members of shareholders *which he knows or has a reasonable cause to believe that the dividend was fictitious* [emphasis added].

In every analyses of receipt of the improper dividends, an inquiry is made on the faith of the shareholder whether it is good or bad in receiving such dividend and whether the company is solvent or insolvent at the time of payment of dividend and at the time of the suit. [579] As it is evident from the different rules applied by the most of the states, a shareholder who is in a good faith receives illegal dividend from solvent corporations are not required to refund.[580]On the other hand, in the number of states the shareholder are required to refund unlawful dividends even though the company was solvent both at the time of payment of dividend and suit so long as the shareholder had received the divided in bad faith. [581] On the third scenario, if the divided paid from the capital of the company and as a result the company was insolvent, the creditors are entitled to claim injury and the divided will be refunded from the shareholderwhether they are in bad or good faith.[582]

Unlike many jurisdictions, the Ethiopia share company law failed to claim back the unlawfully distributed dividend unless it was made in the family company and where distribution was made in the absence of a balance sheet or not following the approved balance sheet.[583]By doing so, the commercial code tries to incline to the interested shareholder with the general motive of encouraging investment than creditors. [584] As the expose demofti of this commercial code asserts that "Shareholders who never intimately involved in the management of the company practically are obliged to accept the accounts given them and should not be required unravel the numerous

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[578]*ibid*
[579]David A. Witz, 'Shareholders' Liability for Dividends Improperly Declared and Paid', *SMU Law Review*, Volume 1 | Issue 2 Article 6, 1947, p. 226
[580]*Ibid*
[581]*Ibid*
[582]*Id, p. 227*
[583]Supra note 4, Com code art 459
[584] See art 439 of the draft commercial code, it maintains the existing provision

procedures by which one could disguise distribution of fictitious dividend sub fictitious repayment." According to this background document, rather than adopting a knowledge element to claim back the unlawfully distributed dividend from a shareholder, it enables them to hold such dividends by assuming shareholders as they never been the participant of the management. What if shareholders get to know the dividend was fictitious? From the perspective of creditor's protection, not requiring unlawfully distributed dividends to be claimed back from shareholder most likely affect the capital of the company in which creditors are looking for.[585] Our share company law in addition to the director's civil and criminal liability, the shareholder who knew or ought to have known there was unlawful distribution should also be liable. This is because, for one thing as the amount fictitious dividend distributed to shareholders might be huge and so that the liability of director's may not produce enough amount that can meet creditor's claim and to make good the already distributed amount. In such a case, even if the creditors could have a chance to recover from shareholders, the law denied such possibilities of their repayment by limiting the duty of claiming back unlawfully distributed dividends from only family companies and distribution made in the absence of a balance sheet. Again, from the perspective of the principle of limited liability, failure to claim back the unlawfully distributed dividends erodes thenormal system of priority rule. In the nut shell,the Ethiopia share company law failed to take an honest approach tothisentire problemby taking in to accountthe interests of both of the shareholder and the creditors. As a result of such failures, the creditors could be suffers when the shareholders receives a return to which he is not legally entitled and which might impairs the securityof the creditor's claim. So long as the shareholder has the knowledge as the unlawful distribution of divided, why would the law permit shareholder to retain thisunjustenrichmentarisingfromaclearviolation ofstatute? In such circumstances justice demand a return of such unlawful dividend.

[585]Supra note 561, Interview with professor TelahuneTeshome, *on the issue of rule of dividend distribution*, September 30, 2020

4.3.3. Protection of creditors in the near of insolvency, the absence of Wrongful trading and fraudulent trading

In the principle of recognizing the very interest of the stakeholders, the OECD principle enshrined that the corporate governance framework should be complemented by an effective, efficient insolvency framework and effective enforcement of creditor rights. [586] With that, it recognizes different frameworks of corporate insolvency across the countries. Among those frameworks for corporate insolvency, the legislative framework which imposes a duty on directors to act in the interest of creditors when the companies are nearing insolvency is the one.[587] In several jurisdictions, there is this legislation that provides that directors must have some regard for the position of creditors when the company is in the vicinity of insolvency. [588] Despite the possibility of such abusive conduct, the Ethiopia share company law failed to incorporate those opportunistic behaviors of the directors that might be performed in the near insolvency called wrongful trading and fraudulent trading. If that so, directors even if they undertake business with the intent to defraud creditors in the course of winding up of the company, they are not liable to make good such contribution to the company's asset. This is to mean, directors in Ethiopia share company law are not liable even if there is actual dishonesty on the parts of them to continue trading and incur debts at the time when there are no reasonable prospects of the creditors ever receiving payments of those debts. The same is true for the director's liability for their wrongful trading. Hence no provision makes the director liable for their contribution to the company's losses as a result of wrongful trading. If that sothe director rather than taking every step to minimize the potential loss to the creditor, trade-in situation where there is no reasonable prospect of the company avoiding going into insolvent liquidation. However, rules of such kind play an important role in cushioning directors when the company is going concerned and acts in the very interest of creditors. The absence of such a legal strategy creates an incentive for directors to act recklessly and fraudulently by engaging in the very risky trading decision.

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[586]Supra note 233, OECD principle, 5, P. 48
[587] OECD, principle explanatory note P. 48
[588]A classic example of this is s.214 of the UK's Insolvency Act 1986 which legislates against what it calls "wrongful trading and fraudulent trading

Chapter Five Recommendations and Conclusion

5.1. Conclusion

The very objective of this study is to critically analyze the legal framework on the protection of corporate creditors under Ethiopian share company law and to evaluate its adequacy in light of international recommendations. More specifically, it aimed to address legal and regulatory issues surrounding the protection of corporate creditors in Ethiopia. To analyze the very protection given to the corporate creditors in Ethiopia Share Company law, those principles embodied under the OECD principle on corporate governance and the doctrine of capital maintenance serves as an important benchmark. Based on such major objective, this paper critically analyzes whether the Ethiopia share company law provide adequate protection for corporate creditors by using the above cited principles.

As corporate creditors are dealing with a business venture where the member is only liable to the extent of their investment, legislatures have attempted to mitigate the blind effect of the principle of limited liability to provide some degree of protection for creditors. The notion of creditor protection is understood as mechanisms that aims to protect the interest of a person designated as a creditor.

This research has tried to see the protection of corporate creditors under Ethiopian share company law. In Ethiopia Share Companycorporate governance, the Ethiopia share company law recognizes the place and the right of creditors in relation to the mandatory disclosure and capital maintenance provisions. But, the protections afforded to corporate creditors are not adequate enough as can be assessed by the modern principles such as the OECD principle on corporate governance and doctrine of capital maintenance.

Though the Ethiopia share company law contained some provision on the mandatory disclosure of the financial and non-financial information, there are still legal as well as practical gapssurrounding mandatory disclosure. These are: first though the law mandates all the reporting entity to adopt IFRS and submit financial reports to the AABE practically, it is not all the reporting entities including share companies are implementing IFRS and they are not still

under duty to report those financial statements to the board in accordance with the proclamation. Secondly, though the financial reporting proclamation 847/14 enable interested third parties including creditors to access those submitted financial statements as one way of disclosure, the board do not have personnel to clarify the very meaning of the submitted financial statement tocreditors and other third parties as they may not be in a position to understand those technical financial statements.

Let alone this financial reporting under the this proclamation, there are also some practical problems in the implementation of the some provisions of the commercial code. First, as the capital reductions might diminish the fund available to creditor's repayment, requiring adequate safeguards is a common way of protecting creditors against reductions of capital. In line with that, the com code provides the requirements of the publication of reduction of capital together withan entry to into registration. Further, the codes also provides for the mendement of the memorando of association. practically, there is no such requirement of publishig and registering the reduction of capital andthere is no mechanism to enforce such regulatory instrument. Beyound that the companies are not also expected to amend their memorandom of accosiation in case when there is redcution of capital.

Publication of information is one way of effecting disclosure. By using this published information whether it is financial or non-financial, creditors can easily access the information as to the financial position and performance of the company. But both the legal and practical observance indicatethat publication is the most neglected way of discloser mechanism in Ethiopia. For instance, though the law requires the publication of a balance sheet, the fact of reduction of capital, there is no such thing in practice. The absence of such publication is rooted in the absence of the commercial official gazette which the law establishes under the com code. But there isnoeven attempt to replace such Gazzeta by widely circulated Gazzetta to enforce those provisions of commercial code that require publication.

Empowering and strengthen the commercial registrar has been one the most important mechanism to effectively implement the mandatory disclosure rules like that of the publication. But the legally assigned responsibilities of the Ethiopian business lensing registration institution are not practically implemented. For instance, when the capital is reduced, an entry to registry should be made but this is the practically nonexistence.

The issuance of a prospectus which is an important source of information as to the offer of shares or debentures to the public lacks the disclosure of financial information prepared in accordance with the modern accounting and auditing standards. Beyond that, the law also failed to require the publication of such prospectus to be published and registered in the commercial registerso that third parties including creditors could access easily.

As one mechanism of legal capital rule, the minimum capital requirements do not provide real protection for creditors. This is because, one of the objectives of the law in providing minimum capital requirement is to prevent the company from undercapitalization. In the first place, the fact that the company fulfilled the minimum capital requirement doesn't mean that the company has enough capital for a business. Secondly and most importantly, even if it believed to have minimum capital, difficulties will arise in quantifying the minimum amount as most of the time there is no meaningful relation between riskiness of the businesses and the amount of minimum capital. Thirdly, the Ethiopian minimum capital requirement for Shares companies i.e. 50, 000 is a trivial amount and it doesn't consider the current devaluation of currency and inflation.

Though the provision of capital maintenance which aimed at the preservation intact of the capital of the company tried to be endorsed in Ethiopian share company law, the area is still blamed as it failed to provide effective corporate creditor protection. These problems of capital maintenance are revolving around the three major rules of capital maintenance such as rules on dividend distribution, on the valuation of in-kind contribution, and joint or cross-holding.

Valuation of an in-kind contribution is the most delicate problem as it calls the risk of overvaluation. The procedures adopted by the Ethiopia share company law to verify valuation of contribution in kind is not adequately protected corporate creditors as power to value-in-kind contribution is given for shareholder themselves rather than an independent expert. This creates incentives for shareholders to engage in the overvaluation practice to get a good amount of borrowing. In this case, the law doesn't take a preventive approach to controlling such act of overvaluation and related problems of in-kind contribution. In addition to that, the level of tolerance in case when there is discrepancy in valuation of property is huge amount which most likely affect the capital of the company. Further, the code is also failed to state the usefulness of in kind contribution in line with the business purposes of the company. Not only this, it also failed to expressly prohibit the contribution of the services as onenon cash contribution.

Cross holding which have a negative effect on the maintenance of share capital is poorly regulated in Ethiopia. Though the law tries to control joint holding to a certain extent (such as 10% and beyond), its regulation is not any more than the joint holding of shares as between two companies. But the law has failed to consider the practical circumstances whereby the joint holding can happen in more than two companies. In addition, the law also failed to device mechanism to disclose the fact of joint holding to third parties including creditors. What is more, the MOT which mandated to control the overall aspects of the joint holding never regulates the holding of companies jointly.

The Ethiopia share company law also failed to incorporate adequate protection for corporate creditors in the case when there is an unlawful distribution of dividends which impairs legal capital. Unlike many countries which provide the claiming back of the dividend paid unlawfully based on the faith of the shareholder and the solvency of the company both at the time of the payment and suit, the Ethiopia share company law failed to this adopt a balanced approch by limiting the claiming back of the unlawful divided only from the family company and divided madein the absence of balance sheet or approved balance sheet. As unlawful dividend has a great possibility of reducing the value of capital, the creditors' rights of being paid before shareholders are eroded and the creditor may end up unpaid. This defeat the normal system of the rule of priority applied to limited liability business venture.

Apart from this, the Ethiopia share company law has also failed to incorporate those rules which govern the opportunistic behavior of the directors s in the near of insolvency. In line with that, the law does not require the personal liability of directors for their fraudulent and wrongful trading in the near of insolvency. Had been this regulation, the creditors would be in a better position to be protected in the near of insolvency.

5.2. Recommendation

Based on the findings and the conclusion of the study, the researcher recommends the following

- The legislator needs to reform the share company law including the commercial code in lights of the accepted international principles and recommendations such as the OECD principle of corporate governance and doctrine of capital maintenance.
- In order to address problems regarding to the corporate disclosure including financial reporting, an attempt should be made on the effective implementation of proclamation financialreporting no 847/14. So that, the defects of the commercial can be rectified. Further, the modern accounting and audited standard should be adopted by all companies by addressing the current practical problems as the creditors mainly rely on the financial statements made as per this accounting standard. Beyond that, the prospectus issued by the company to issue debentures should include the financial information prepared in accordance with the modern accounting standards adopted by the country and publish and register in commercial registry.
- For the effective disclosure rights of the creditor, the legislator should consider using the modern age of digitalization effectively so that the information can be available from the company's home page in a more convenient, easy, and cost-effective way. Further, to effectively exercise the rights of creditors to inspect any financial statements and auditors report provided under proclamation no 8472014, the law should consider the technicality of this information and needs to employees professionals which explains the meaning of disclosed financial statements and auditors report so that they will be in a better position can understand these financial statements and can make informed decision.
- In order to address the problem of publication of the balance sheet, capital reduction, and the like important information, the legislator should consider for the publication to be made in a widely circulated newspaper if establishing commercial official gazette is difficult.
- To address those problems concerning a lack of effective monitoring on the part of the commercial register, the government should improve the public register to present the financial and non-financial information in a more user–friendly fashion. One way of doing so may be establishing a specialty of company register so as to handle the whole

registration process together with the supervisory role after the formation of Share Company. By doing so the register can effectively handle those legal duties assigned by the law such as presenting information for the outsider of the company and to effectively monitor the companies including the reduction of capital as per the commercial code and other relevant legislations.

- Regarding the joint holding of shares, the law needs to recognize the possibility of cross-holding in more than two companies. Accordingly, the law should come up with a clear provision of the law that coup up with reality. So that the legislator should consider the possibility of joint holding as between and among companies and should govern the situation accordingly.The legislator should also devise a mechanism to disclose the existence cross-holding of shares as between and among companies to third parties including creditors. So they can make an informed decision accordingly.
- The commercial code should abolish the minimum capital requirements for share companies. Rather than relying on uniformly imposed and trivial amounts of money as a minimum capital, creditors can be better protected by mechanisms by considering the commercial risk, income statement, business plan, and other important indicators.In place of this minimum amount requirement, it is better to enforce mandatory disclosure of information as it stated above by mandatory filing of financial statements incompany registriesand enhance the supervisory role of company registries.
- In order to address the problems related to in kind contribution, it is recommended for the legislator to keep the existing provision of the commercial code on the valuation of in-kind contribution so that the expert appointed by MOT can evaluate the in-kind contribution.Further, in relation to the nature of in kind contribution, the law should require the in kind contribution to be useful in order to attain the business purposes of the company like that of partnership. Further,the law should also expressly prohibit the contributions of the serveries as one type of non-cash contribution as it affects the creditors.
- The legislator should also consider revision on the rule of dividend distribution. More specifically, the legislator should stipulate a provision to claiming back of the dividend paid unlawfully based on the faith of the shareholder and hat of the financial status of the

company. By doing so, the law can adopt the balanced approach which takes in accounts both the interest of creditors and creditors.

- Finally, the legislator should include rules which govern the opportunistic behavior of the directorss in the vicinity of insolvency. As the capital maintenance rules by itself is not govern the opportunistic conduct on the part of the company controllersit would be appropriate to supplement the capital maintenance rule with the rule with ex post provisions designed to counter the opportunistic behavior of shareholder arise in the vicinity of insolvency.

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