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SHAREHOLDERS LIABILITY TO TORT CREDITORS DUE TO POLLUTION OR WASTES OF COMPANY'S IN ETHIOPIA

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School of Law,

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March, 2017

SHAREHOLDERS LIABILITY TO TORT CREDITORS DUE TO POLLUTION OR WASTES OF COMPANY'S IN ETHIOPIA

Thesis

Submitted in Partial Fulfillments of the Requirements for the Degree of Masters of Laws (LLM) in Business and Corporate Law at the School of Law, Bahir Dar University

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June, 2017

Approval Sheet by the Board of Examiners

The thesis titled "shareholders liability to tort creditors due to pollution or waste of company's in Ethiopia" by Mr. Mulugeta Tsegaw is approved for the degree of Master of Laws (LLM).

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Declaration Statement

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

Acknowledgment

First and foremost, my thank goes to the Almighty, Jesus and His Mother, St. Mary, as they are always by my side and gives me non reserved protection. Second, I would like to extend my deepest gratitude and appreciation to my advisor Dr. Solomon Abay for his invaluable and constructive feedbacks and comments on the proposal as well as the organization of this thesis. . Next, the turn is to my parents for their whole embracing ideal support. Last but not least, I would like to thank all my friends who gave me their moral support and valuable research ingredients during the preparation of the thesis.

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Mulugeta Tsegaw Siyum

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List of Abbreviations/Acronyms

Cum.	Cumulative
EEPA	Ethiopian Environmental Protection Authority
EEPC	Ethiopian Electric Power Corporation
EPA	Environmental Protection Authority
FDRE	Federal Democratic Republic of Ethiopia
LLCs	Limited Liability Companies
Procl.	Proclamation

Abstract

One of the major attractions of the corporate form is limited liability, which permits those who invest in an incorporated business to limit potential losses. Limited liability allows for 'risk sharing' between the owners of the company and the outside parties with whom the company interacts. If the company fails, the effect of the doctrine is that losses are partly externalized – they fall upon external creditors. Although this is generally seen as acceptable in the ordinary course of commerce, where incorporated businesses benefit from reciprocal risk transfers, it proves to be far less palatable where the costs of business failure fall upon tort claimants. Unlike contractual creditors, tort claimants are unlikely to have opportunities to deal with the company that injures them. They require special protection by the law. However, the problem facing tort claimants has been the preference of the law to uphold limited liability at the expense of both ordinary tort doctrines and the principle of full compensation for wrongs.

Recent scholarship has sought to re-examine current rules of risk-sharing between the owners of incorporated businesses and outside parties, including the rule of shareholder limited liability. Thus, scholars have noted the changed role of shareholders within the corporation. Shareholders can no longer always be assumed to be passive investors. Indeed, they might prove pivotal in business decision-making. This has led to a number of doctrines to make shareholders liable to company's tort creditors. Scholars have noted, further, the injustice that accompanies the judgment-proofing of companies when this means denying full compensation to tort claimants injured by corporate wrongdoing.

This thesis is, therefore, aimed at, having the above facts in mind, analyzing the situations of Ethiopia. That is, to critically enquire whether there exist grounds that give rise to the liability of shareholders for the torts committed by their companies in which they invest; whether the existence of the above problem(s) are backed up or regulated by the law; and finally what the different doctrines proposed at the international level says in relation to it.

Key Words: Company/Corporation, Shareholders, Liability, Tort Creditors, International Doctrines, Grounds, Domestic Laws, Ethiopia.

CHAPTER ONE

SHAREHOLDERS LIABILITY TO TORT CREDITORS DUE TO POLLUTION OR WASTES OF COMPANY'S IN ETHIOPIA

1. Introduction

1.1. Background of the Study

A company, as defined by Gogna, is "a voluntary association of persons formed to achieve some common objectives, having a separate legal entity, independent and separate from its members, with a perpetual succession and a common seal, and with capital divisible into transferable shares."[1]

As a legal person a company has certain powers 'necessarily and inseparably incident to every corporation' such as the power to conclude contracts.[2]Owing to the doctrine of limited liability, the transactions of a share company create legal rights and obligations vested in the company itself as opposed to its members. Since a company is a separate legal person with property interests, it will alone be liable for the debts it incurs. This means that, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their private funds.[3]

Limited liability allows for 'risk sharing' between the owners of the company and the outside parties with whom the company interacts and if the company fails, the effect of the doctrine is that losses are partly externalized – they fall upon external creditors.[4] Although this is generally

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[1]Gogna, P.P.S (2004), *A Textbook of Company Law, 2004,* (New Delhi: S. Chand & Company Ltd.), P. 9 as cited in Endalew Lijalem, The Doctrine of Piercing the Corporate Veil: Its Legal Significance and Practical Application in Ethiopia, *Mizan Law Review*, 2012, Vol. 6, No.1, PP. 77-114, 2012, at P.98 -101[Herein after, Endalew Lijalem, The Doctrine of Piercing the Corporate Veil: Its Legal Significance and Practical Application in Ethiopia]

[2] J.L. Stewart and M. L. Palmer, *Company Law of Canada*, 1962, (Toronto: The Carswell Company Ltd,5th ed.) P. 46, as cited in Seyoum Yohannes Tesfay, on Formation of Share Companies in Ethiopia, PP. 102-127, at P. 104[Herein after, Seyoum Yohannes, on Formation of Share Companies]

[3] Dine Janet and Koutsias Marios, *Company Law*, 2007, 6th ed., London: Palgrave Macmilan, P.2 as cited in Endalew Lijalem, The doctrine of piercing the corporate veil: Its Legal Significance and Practical Application in Ethiopia, P. 82

[4] Contractual Creditors refers only to voluntary creditors (i.e. all of the creditors who contracted with the company at their own will).See also Olga Petroševičienė, Effective Protection of Creditors' Interests in Private Companies: Obligatory Minimum Capital Rules Versus Contractual and Other Ex Post Mechanisms, *Social Sciences Studies,* 2010, Vol. 3, No. 7, PP. 213-228, at P.221

seen as acceptable in the ordinary course of commerce, where incorporated businesses benefit from reciprocal risk transfers, it proves to be far less palatable where the costs of business failure fall upon tort claimants.

This is because, at the outset of their relationship with the company, creditors can contract[5] for an adequate interest rate, possibly, for control rights on the company,[6] and ask for additional securities from the company.[7] Moreover, recently, under the current conditions of economic recession, creditors also ask for personal securities of shareholders for the obligations of the company. In such cases, creditors 'contract out of the doctrine of limited liability'.[8]

On the other hand, the company law protected the interest of shareholders of a company through the application of the doctrine of limited liability (save in exceptional cases) which, among others, shifts some of the costs of innovation and its failures to the creditors and employees of companies.[9]Limited liability is one of the major attractions of the corporate forms which permit those who invest in an incorporated business to limit potential losses.[10]Be that as it may, tort claimants are, however, unlikely to have opportunities to deal with the company that injures them.[11]

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[5] Luca Enriques and Jonathan R. Macey, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, *Cornell Law Review*, 2001, Vol. 86, No. 1165, PP. 1168 and ff, at P. 6. <http://scholarship.law.cornell.edu/clr/vol86/iss6/>. [Herein after, Luca Enriques et al, Creditors Versus Capital Formation] See also Barry E. Adler and Marcel Kahan, The Technology of Creditor Protection, *University of Pennsylvania Law Review*, 2013, Vol. 161, No. 7, PP. 1773-1814, at P. 1778.

[6] For instance, a debtor is usually not entitled to invest, purchase or acquire assets of a particular value, to borrow or to lend particular sums, to mortgage or pledge real property, etc. without a prior written consent of the creditors. See Id, P. 221.

[7]The securities may include real estate mortgage, pledge, bank guarantee, etc. See Ibid.

[8] Machado, F. S. *Mandatory Minimum Capital Rules or Ex Post Mechanisms*?, P.28 at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568731>[last accessed February 14, 2017]

[9]L.C. Backer, *Comparative Corporate Law*, Op cit, 995 as cited by Seyoum Yohannes, on Formation of Share Companies, P. 105

[10] Christian Witting, Liability for Corporate Wrongs, *The University of Queensland Law Journal, 2009,* Vol. 28, No. 1, PP. 113-142, at P. 113. [Herein after, Christian Witting, Liability for Corporate Wrongs]

[11] Stephanie Ben-Ishai and Stephen Lubben, Involuntary Creditors and Corporate Bankruptcy, *UBC Law Review*, 2012, Vol. 45, No. 2, PP. 253-282, at P. 257 [Here in after Ben-Ishai et al.,, Involuntary Creditors and Corporate Bankruptcy]; It is argumentative whether the so-called 'involuntary creditors' excludes employees, consumers, trade creditors, and lenders. See Frank H. Easterbrook and Daniel R. Fischel, Limited Liability and The Corporation, *The University of Chicago Law Review*, 1985, Vol. 52, No. 1, PP. 89-117, at P. 89 [Here in after, Easterbrook et al., Limited Liability and The Corporation]

Most of the damages to tort creditors arise due to Changes in technology, knowledge, liability rules, and procedures for mass tort litigation which have for the first time raised the prospect of tort claims that exceed the net worth of even very large corporations.[12]Environmental harms, such as oil spills or the release of toxic materials, are one potential source of massive liability; hazardous products and carcinogens in the workplace are others.[13] It is, thus, held that shareholders can no longer always be assumed to be passive investors. Indeed, they might prove pivotal in business decision-making. Owing to this, different doctrines are being proposed in recent academic discourse to make all shareholders liable to company's tort creditors. These doctrines are: Gordon G. Sollars's Shareholder Proportionality Liability,[14]Henry Hansmann and Reinier Kraakman's Shareholders Unlimited Pro rata Liability,[15]Nina Mendelson's Control Based Approach,[16]Christopher Kutz's Shareholders Intention Approach[17]and Christian Witting's Modified Limited Liability Approach.[18]

When we look at the Ethiopia's situation, it has incorporated separate legal personality and the doctrine of limited liability of companies in its commercial code.[19]But, the incorporation is justified from the point of view of the relationship between shareholder and contractual creditors of a company. The doctrine of limited liability has applied against the interest of tort creditors without any justification. There is no any provision which held all shareholders liable for the wrongs committed by their companies by mere fact that they are shareholders.

[12] Henry Hansmann and Reinier Kraakman, 'Toward unlimited shareholder liability for corporate torts', *The Yale Law Journal*, 1991, Vol. 100, No. 7, PP. 1879-1934, at P. 1880[Herein after, Henry Hansmann et al., Toward Unlimited Shareholder Liability for corporate torts]

[13] Ibid; See also A. Sushil Kumar, 'Mega hazards': The New Threat, *Economic and Political Weekly*, 1987, Vol. 22, No. 11, PP. 448-449, at P. 448 [Here in after, Kumar, 'Mega hazards': The New Threat]

[14]Gordon G. Sollars, An Appraisal of Shareholder Proportional Liability, *Journal of Business Ethics* 32,*Kluwer Academic Publishers, 2001,* PP. 329-345, at P. 329 [Herein after, Sollars, An Appraisal of Shareholder Proportional Liability]

[15]Henry Hansmann et al, Toward unlimited shareholder liability for corporate torts, P. 1880

[16]Nina A. Mendelson, A Control-Based Approach to Shareholder Liability for Corporate Torts, *Columbia L.aw Review*, 2002, Vol. 102, No. 5, PP. 1203-303. [Herein after, Nina A. Mendelson, A Control-Based Approach to Shareholder Liability]

[17]Christopher Kutz, *Complicity – Ethics and Law for a Collective Age,* 2000 [Here in after, Kutz, Complicity – Ethics and Law for a Collective Age]

[18]Christian Witting, Liability for Corporate Wrongs, PP. 113-142

[19]Commercial Code of the Empire of Ethiopia, 1960, *Negarit Gazette*, Extraordinary issue, Proc. No.166/1960, 19 year, No.3. Articles 304 & 510.[Herein after, Commercial Code]

All the above factors indicate that the issue of protection of tort creditors is an issue of many jurisdictions including Ethiopia. This paper, therefore, argues that to give adequate protection to tort creditors it is appropriate to make all shareholders liable for personal injuries inflicted by companies in which they hold shares. Here, the paper is limited to the liability of shareholders to tort creditors due to pollution or waste of companies in Ethiopia.

1.2. Statement of the Problem

Under Ethiopian Commercial Law there are two types of companies,[20] namely Share Company and Private Limited Company.[21]In both types of companies legal personality is acquired by fulfilling the various requirements of the Commercial Code of Ethiopia.[22] Due to its separate legal personality, a company is a subject of rights and obligations, in its own right, distinct and separate from its shareholders, directors and managers. It may therefore, enter into any kind of juridical acts such as contracts.[23]

Besides, the commercial code incorporated the doctrine of limited liability for both types of companies'.[24]Since a company is a separate person with property interests, it will alone be liable for the debts it incurs. This means that, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their private funds. The shareholders are liable only to the extent of the amount they have paid, or have promised to pay, for their shares.[25]Hence, a company is responsible for its own actions and will be predominantly liable for its own debts and the company's creditors cannot seek the

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[20] While the term 'Company' is used in the Ethiopian legal system, the term 'Corporation' is commonly used in the common law legal system though it is broader in concept which includes public enterprises. Since the doctrine of piercing the corporate veil is of common law origin, the term corporation is seldom used in this article particularly in sections dealing about foreign laws and not to confuse it with the term company. However, the term company is exclusively used in the sections dealing with the legal and judicial recognition of the doctrine in Ethiopia. See also Shittu A. Bello1 and Ogwezzy C. Michael, *Review of Contemporary Business Research*, 2014, Vol. 3, No. 2, PP. 117-138, at P. 118 & 119

[21] Commercial Code, Article 510. A private limited company is a company consisting of two to fifty members who are liable only to the extent of their contribution. It is always commercial in form and governed by the Commercial Code provisions of Arts. 510- 543 and the general provisions applicable to all forms of business organizations (Arts. 210- 226).

[22] Commercial Code, Articles 223, 323, 324.

[23]Seyoum Yohanness, On formation of Share Companies, P. 104

[24] Commercial Code, Articles 304 and 510.

[25] Luca Enriques et al, Creditors Versus Capital Formation, P. 2

satisfaction of their claims from the members even if the company's funds (assets) are insufficient to pay its liabilities in full. The same is true for shareholders.

As addressed by Nigussie Taddesse[26] although limited liability is an advantage for shareholders, it may, however, greatly affect the interest of creditors mainly that of tort creditors in different ways such as: Shareholders who employ the company's name through which to contract with others may misrepresent the assets of the company and simply walk away if the business fails,[27] engage in asset diversion for example via making distributions to themselves in the form of dividend payments, share buy-backs, and excessive salaries, engage in claim dilution by issuing additional debt of the same or higher priority,[28] or more subtly, shareholders or directors may undertake highly risky (volatile) investments or increase leverage in order to shift uncompensated risk onto the shoulders of creditors.[29]Similarly, Endalew Lijalem[30]addressed the possibilities for shareholders of companies to engaging in different illegal activities such as fraud thereby affecting the interests of creditors.

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[26]Nigusie Tadesse, *Major Problems Associated with Private Limited Companies in Ethiopia: the Law and Practice,* 2009,LLM, senior Thesis, Addis Ababa University, Law faculty, [unpublished available at law library], P. 147-156[Herein after, Nigusie Tadesse, Major Problems Associated with Private Limited Companies in Ethiopia: the Law and Practice]

[27] Allen William T., Kraakman Reinier, and Subramanian (2007), *Commentaries and cases on the law of business organizations,2007,* 2nd ed., New York: Aspen publishers, P. 131; See also Nina A. Mendelson, A Control-Based Approach to Shareholder Liability, P. 1203.

[28]Sollars*,* An Appraisal of Shareholder Proportional Liability, P. 329; see also Nigusie Tadessie, Major Problems Associated with Private Limited Companies in Ethiopia: the Law and Practice, P. 147- 156

[29] Ibid.

[30]Endalew Lijalem, the doctrine of piercing the corporate veil: Its Legal Significance and Practical Application in Ethiopia, P. 98-101

Moreover, Tamiru Alemayehu,[31] Selamawit Kifle,[32] Tesfay Aregawi,[33] Arega Shumetie Ademe and Molla Alemayehu,[34] Teklit Gebregiorgis[35] and Animaw Demis[36] studied that the concentration of chemical constituents are presumed to have been released from both domestic and industrial activities increase downstream and the high abundance of such chemical constituents that do not concentrate naturally is strong evidence of water (which may serve for various purposes such as horticulture, drinking water for cattle, washing and for other domestic activities) pollution by industrial wastes. These pollutions are causing different health problems. These are really the major grounds that give rise to the liability of companies (industries) to the tort victims and to shareholders if the company fails to meet its tort liabilities.

Despite the existence and or potential existence of the above problems, what the Ethiopian Commercial law provides is only for the liability of members who are involved in the management of a company that has become bankrupt unless they rebut the presumption of non-diligence by proving that "they have acted with due care and diligence; for the joint and several liability of founders(assuming that they are members) in respect of the commitments entered into for the formation of the company unless they were necessary for the formation of the company or approved by the general meeting of the subscribers; for the declaration of bankruptcy of any

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[31] Tamiru Alemayehu, The Impact of Uncontrolled Waste Disposal on Surface Water Quality in Addis Ababa, Ethiopia, Ethiop. J. Sci. Vol.24. No. 1, PP. 93-104 [Herein after, Tamiru, The Impact of Uncontrolled Waste Disposal on Surface Water Quality in Addis Ababa]

[32] Selamawit Kifle Ayele, *Industrial Waste and Urban Communities in Addis Ababa: The Case of Akaki Kaliti and Kolfe Keranio Sub Cities*, and Development Management, [unpublished], P.21 [Here in after, Selamawit, Industrial Waste and Urban Communities in Addis Ababa: The Case of Akaki Kaliti and Kolfe Keranio Sub Cities]

[33] Tesfay Aregawi, Peculiar Health Problems Due to Industrial Wastes in Addis Ababa City: the Case of Akaki Kality Industrial Zone, 2014, A Thesis submitted in partial fulfillment of the requirements of Master of Arts Degree in Public Administration and Development Management, [unpublished], P. 29 [Herein after, Tesfay, Peculiar Health Problems Due to Industrial Wastes in Addis Ababa City: the Case of Akaki Kality Industrial Zone]

[34] Arega Shumetie Ademe and Molla Alemayehu, 2014, Source and Determinants of Water Pollution in Ethiopia: Distributed Lag Modeling Approach. *Intel Prop Rights, Vol.* 2, No. 110., PP. 2-6, P. 2 and 3at <doi:10.4172/ipr.1000110> [Herein after, Arega Shumetie et al, Source and Determinants of Water Pollution in Ethiopia]

[35] Teklit Gebregiorgis Amabye, Plant, Soil and Water Pollution Due to Tannery Effluent: a Case Study From Sheb Tannery, P.L.C,Wukro Tigray, Ethiopia, *Science Journal of Analytical Chemistry.* 2015,Vol. 3, No. 5, 2015, PP. 47-51, at P. 50 and 51[Herein after, Teklit, Plant, Soil and Water Pollution Due to Tannery Effluent: a Case Study From Sheb Tannery]

[36] Animaw Demis Ejigu, *Corporate Social Responsibility in Ethiopia: Case Study of Bahir Dar and Habesha Leather Factories,* 2016, Thesis Submitted in Partial Fulfillments of the Requirements for the Degree of Masters of Laws (LLM) in Business and Corporate Law at the School of Law Bahir Dar University, [unpublished], P. 64 [Herein after, Animaw, Corporate Social Responsibility in Ethiopia: Case Study of Bahir Dar and Habesha Leather Factories]

person who has carried out commercial operations on his own behalf and disposed of company funds as though they were his own and concealed his activities under the cover of such company; for the liability of a person who manufactures goods and sells to the public for profit and causes any damage to another person resulting from the normal use of goods and for the liability of a person who exposes another to abnormal risk, by using or storing explosive or poisonous substances, or by erecting high-tension electric transmission lines, or by modifying the lie of the land, or by engaging in an exceptionally dangerous industrial activity, where the danger he has created materia1ises, thereby causing damage to another.[37]

Thus, while the last two situations provides only for the liability of the company itself without saying anything about the liability of the members; in the first three situations the Ethiopian Commercial law does not address for the liability of shareholders if they do not participate in the situations so mentioned.

Moreover, the number of those persons who are involved in the management is very few compared to non manager members and hence it is unthinkable that they will adequately satisfy the claims of tort creditors.[38]The same is true for the other persons who are involved in the situations mentioned above. To add insult to injury, while one of the mechanisms of protection of tort creditors was being prioritizing their claims in the secured credit systems, [39] let alone holding shareholders liable for the wrongs committed by their companies, the Ethiopian Commercial law does not even prioritize the claims of tort creditors on the winding up of the company.[40]

All the above issues clearly show that what the Ethiopian Commercial law provides is for the liability of those members who are involved in the above situations. If the members do not involve in the situation so mentioned, they will not be held liable by the mere fact that they are

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[37] Commercial Code, Articles 530, (307 and 308), 1160, 2085 and 2069; see also Endalew Lijalem, the doctrine of piercing the corporate veil, P. 98 -101

[38]Fekadu Petros Gebremeskel, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *Mizan Law Review*, 2010, Vol. 4 No.1, P. 2 [Hereinafter, Fekadu Petros, Emerging Separation of Ownership and Control]

[39] Christopher M. E. Painter, Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times, *Stanford Law Review*, 1984, Vol. 36, No. 4, PP. 1045-1085, at P.1076

[40] Commercial Code, Article 1110

shareholders even if they benefit from the arbitrary gains deliberately taken in their behalf. Thus, tort creditors remain with no any legal recourse against all shareholders.

The fact that the limited liability doctrine gives companies the ability to externalize costs reduces companies' incentives to take care in the conduct of their activities. More persons are injured than would otherwise be the case. Therefore, since the Ethiopian law does not give adequate protection to tort creditors, the researcher believes that significant legal protection of tort claimants is required against the company – and, so it will be argued, its owners.

1.3. Objectives of the Study

This research has both general and specific objectives.

1.3.1. General objective

The general objective of this study is to indentify, investigate, and critically analyze whether all shareholders be liable to company's tort creditors in Ethiopia.

1.3.2. Specific objective

The researcher derived the following specific objectives from the above general objective. The specific objectives are the following:

- To critically investigate and analyze whether all shareholders are made liable to company's tort creditors under Ethiopian laws and to show the existing gaps, and
- To critically examine the different doctrines adopted by different legal scholars at the international level and to recommend the doctrine which is/are appropriate to the Ethiopian context?

1.4. Research Questions

To properly understand the statement of the problem and achieve the above stated objective, the researcher formulated the following main and specific research questions.

1.4.1. *Main Research Question*

- Should all shareholders be liable to Company's tort creditors in Ethiopia?

1.4.2. *Specific Research Questions*

The researcher formulated the following specific research questions from the above general research question.

- Are the problem(s) faced by tort creditors addressed under Ethiopian laws?
- What doctrines are being proposed at the international level to make all shareholders liable to Company's tort creditors and which one is/are appropriate to the Ethiopian context?

1.5. Significance of the Study

This research paper has the following merits:

1. For the law maker: to make tort laws based on fair and efficient doctrine of shareholders liability to company's tort creditors.

2. For the Judiciary: to apply the law properly via:

(i) Determining the person(s) who should be liable to tort creditor of a company,

(ii) Determining the extent of shareholder liability to tort creditor of a company; and

(iii) Giving justice and protect the interest of innocent tort creditor.

3. For the legal practitioners, advocates and officer of a company: to advice the company, shareholder and any interested person in line with (supposedly) the newly enacted tort law.

4. For academicians and other stakeholder: to enrich their knowledge and initiate them for further research on the subject matter.

1.6. Literature review

Taking cognizant of the damages faced by tort creditors, which is beyond the company's asset, different legal scholars have proposed different doctrines on the ground that shareholders should be personally liable to such tort creditors. The doctrines are provided as follows:

Gordon G. Sollars's Shareholder Proportionality Liability[41]: Sollar argued that each shareholder would be liable for the excess of liabilities over the corporation's assets to the extent of the proportion of her shares to the total number of shares outstanding.[42] This is because those who have a chance of receiving arbitrary gains resulting from actions deliberately taken in their behalf must also be subject to the possibly of bearing the arbitrary losses that might be associated with such actions.

Henry Hansmann and Reinier Kraakman's Doctrine of Shareholders Unlimited Pro rata Liability[43]: In a well-known paper, Hansmann and Kraakman argue in favour of pro-rata unlimited liability for the torts of the company to be attached at the time of knowledge that claims will be made. The reason for extended shareholder liability for the torts of the company is to ensure that 'share prices reflect tort costs'.[44] Lower share prices mean greater pressures on managers. Such pressures will induce managers to properly consider risks and communicate fully about projects in which they believe the company should invest.[45] Overall, the result should be the undertaking of a lower level of risky activity than presently occurs. This doctrine has also been the subject of substantial criticism.

Nina Mendelson's Control Based Approach[46]: Mendelson believes that all shareholders with the capacity to exercise control should be liable in an unlimited amount. This is on the basis that those who control the company have, among others, better access to information than do ordinary shareholders, and the ability to control the payment of dividends.[47] And Mendelson

[41] Sollars, An Appraisal of Shareholder Proportional Liability for Corporate Torts, P. 329
[42] Ibid
[43] Henry Hansmann et al, Toward unlimited shareholder liability for Corporate Torts, PP. 1879-1934.
[44] Id, P. 1903
[45] Id, P. 1907
[46] Nina A. Mendelson, A Control-Based Approach to Shareholder Liability for Corporate Torts, PP. 1203-303.
[47] Id, P. 1206

recognizes an important point about companies that injure – that key shareholders have a greater capacity to avoid the causation of harm than do tort claimants.

Christopher Kutz's Shareholders Prior Intention Approach[48]: Kutz is of the opinion that the corporation is a 'co-operative structure'. In such a structure, each individual cooperates by contributing either financial or human capital.[49] 'The corporation and its goals exist only in virtue of this participatory structure. Restricting liability to corporate assets only makes sense on the assumption that there is something, the corporation, and no one else' that stands behind it.[50] He opines that the participatory intentions of shareholders mean that they can be held accountable for the wrongs of the company even if they are not blameworthy.[51]

Christian Witting's Modified Limited Liability Approach[52]: The doctrine of limited liability externalizes risks and the most vulnerable to such risks are tort claimants. The effect of a modified rule of limited liability for personal injuries would be to create a form of strict liability for shareholders with respect to the wrongs of the companies in which they invest. This is to say that shareholders could be held liable for their companies' causation of personal injuries regardless of fault.[53] 'Only strict liability will force each [responsible entity or person] to consider the full social cost of its actions in determining' the level of activity to undertake.[54] Strict liability provides strong incentives for those responsible to either cease the conduct of a particular activity or to put in place policies and procedures that actually work in preventing wrongs occurring. Duty-based regimes are less effective because they require merely that reasonable action be taken.

Coming to Ethiopia, Tamiru Alemayehu studied that the concentration of chemical constituents like Cl, Mn, and Cr in Akaki River, Addis Ababa which are presumed to have been released from both domestic and industrial activities increase downstream and the high abundance of such

[48] Christopher Kutz, Complicity – Ethics and Law for a Collective Age, P. 252
[49] Id, P. 253
[50] Ibid
[51] Id, P. 246
[52] Christian Witting, Liability for Corporate Wrongs, PP. 113-142
[53] Peter Cane, *Responsibility in Law and Morality,* 2002, P. 82
[54] Jennifer Arlen and Reiner Kraakman, 'Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes', *New York University Law Review,* 1997, Vol.72, No.4, PP. 687-779, at P.687, 692.

chemical constituents that do not concentrate naturally is strong evidence of water (which may serve for various purposes such as horticulture, drinking water for cattle, washing and for other domestic activities) pollution by industrial wastes.[55] This pollution is harmful to human health and causes disease.[56]Similarly Tesfaye Aregawi[57] and Selamawit Kifle[58] have also studied on Akaki river and indicated the health problems faced by the surrounding communities as a result of release of chemicals which are hazardous to human health. The same result is reached by Arega Shumetie Ademe and Molla Alemayehu.[59]On the other hand, the study conducted by Animaw on Bahirdar (Dieve Empex Enterprise) and Habesha tanneries revealed that the hazardous chemicals released by such enterprise and factory into river Abay is also causing the same health problems to the nearby residents.[60]

Moreover, Nigussie Tadesse in his Thesis" The problems of private limited companies in Ethiopia"[61]addressed that shareholders of companies with debt have strong incentives to act opportunistically at the expense of existing creditors in a wide variety of ways.[62]Such as shareholder can: (i) engage in asset diversion for example via making distributions to themselves in the form of dividend payments, share buy-backs, and excessive salaries, (ii)engage in claim dilution by issuing additional debt of the same or higher priority, thereby eliminating the advantage of existing creditors' claims on a company's assets if the company becomes insolvent, (iii) profit at the expense of creditors by abandoning projects with a positive net present value if the only benefit from accepting the project accrues to the creditor's, (iv) transfer wealth from contract creditor to themselves by pursuing investment projects that are riskier than the creditors had contemplated when they extended credit.

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[55]Tamiru, The Impact of Uncontrolled Waste Disposal on Surface Water Quality in Addis Ababa, P. 94 and 98
[56] Id, P. 100-101
[57]Tesfay, Peculiar Health Problems Due to Industrial Wastes in Addis Ababa City: the Case of Akaki Kality Industrial Zone, P. 29
[58]Selamawit, Industrial Waste and Urban Communities in Addis Ababa: The Case of Akaki Kaliti and Kolfe Keranio Sub Cities, P. 21
[59]Arega Shumetie et al, Source and Determinants of Water Pollution in Ethiopia, P. 2 and 3

[60]Animaw, Corporate Social Responsibility in Ethiopia: Case Study of Bahir Dar and Habesha Leather Factories, P. 64

[61]Nigusie Tadessie, Major Problems Associated with Private Limited Companies in Ethiopia, P. 147- 156
[62]Gogna, A Textbook of Company Law, p. 6

Similarly, Endalew Lijalemin his article on "the doctrine of piercing the corporate veil**:** its legal significance and practical application in Ethiopia"[63]addressed the possibilities for shareholders to engage in different illegal activities such as concealment.[64]

Therefore, the researcher believes that from the different works of legal scholar, no one worked on the liability of shareholders (by mere fact that they have assumed such status) to tort creditors for pollution or waste of company's in Ethiopia and hence, this guarantees for this research to be undertaken.

1.7. Research Methodology, Data Collection Techniques, Data Analysis and Interpretation Techniques

1.7.1 Research Methodology

The study employed qualitative methodology due to suitability for addressing the research questions of the study and its high degree of flexibility.[65]On top of that, since the study focuses on the reasons, justifications, or logical arguments on legal provisions, qualitative methodology is helpful to: (i) find out a body of laws dealing with the liability of share holders to the company's tort creditors; (ii) analyze how that laws apply; (iii) investigate the gaps in law and (iv) propose a potential solution to the existing gaps in law. Generally, the researcher believes that to answer the research questions and to address the research objectives, the employment of such methodology is crucial.

1.7.2. Data Collection Techniques

The researcher used both primary and secondary sources**.** Primary source are The 1995 FDRE Constitution and different Codes such as The Ethiopian Commercial Code, the Ethiopian Civil

[63]Endalew Lijalem, The doctrine of piercing the corporate veil: Its Legal Significance and Practical Application in Ethiopia, P. 98-101
[64] Ibid
[65] Mike McConville, and Wing Hong Chui, Research Methods for Law, *Edinburgh University Press*, 2007, table 2.1, P. 49

Code, The Ethiopian Criminal Code and Proclamations such as Environmental Pollution Control Proclamation No. 300/2002, and Environmental Impact Assessment Proclamation No. 299/2002. Secondary sources are textbooks, published and unpublished thesis, law journals and internet sources.

1.7.3. Data Analysis and Interpretation Techniques

Once the primary and secondary data are collected, the researcher analyzed and interpreted the existing legislations which have bearing on the liability of shareholders to tort creditors for the pollution or waste of companies in line with different text books, published and unpublished thesis of other researchers and different law journal articles and so on.

1.8. Limitation of the Study

The first limitation of this study is the non-availability of cases online pertaining to tort creditors in Ethiopia. Secondly, shortage of Reference materials for literature review mainly concerning the Ethiopian aspect is a challenge to show full pelage of the legal and conceptual framework of shareholders liability to company's tort creditors in Ethiopia. Time constraint is also another challenges since the research is submitted on the beginning of June 2017. These all are great challenge in conducting this research efficiently and effectively at the required level. Despite the challenges, the researcher determined to conduct, as much as possible, an effective and efficient research and submit it within the given time by exerting his utmost effort to that effect.

1.9. Scope of the Study and Limitation

Firstly, since the study focuses on shareholders liability to company's tort creditors in Ethiopia, it is limited only to Ethiopian Share Company and Private Limited Company. It does not, thus, cover other business organizations such as partnerships and joint venture. Secondly, the possible populations under study are only shareholders. Thus, this research does not cover other

stakeholders such as managers, directors, etc. Thirdly, the victims under study in this research are only tort creditors. And thus, it does not include other creditors such as contractual creditors.

1.10. Structure of the Study

The paper proceeds as follows. The first chapter addresses background of the study, statement of the problem, objective, questions, significance, methodology, scope and limitation of the study. The second chapter deals with the legal grounds of shareholders liability to tort creditors due to pollution or waste company's in Ethiopia. The third chapter examines the different doctrines which deals with the liability of shareholders to company's tort creditors. Finally, the fourth chapter provides conclusions and recommendations.

CHAPTER TWO

2. THE LEGAL GROUNDS OF SHAREHOLDERS LIABILITY TO TORT CREDITORS DUE TO POLLUTION OR WASTES OF COMPANY'S IN ETHIOPIA

The liability of shareholders is limited to their contribution and hence, they cannot be held liable towards paying from their personal assets for the damage caused to tort creditors by their companies. Though this is the case, there are, however, doctrines towards the liability of shareholders even up to their personal assets as long as they are getting arbitrary gains from the activities deliberately taken in their behalf. The aim of this chapter is, thus, assessing whether this is addressed under Ethiopian laws. For this purpose extensive legal analysis and literature review is undertaken.

2.1. The Notion of Limited Liability and the Attributes of Separate Legal Personality in General

A company, as defined by Gogna, is "a voluntary association of persons formed to achieve some common objectives, having a separate legal entity, independent and separate from its members, with a perpetual succession and a common seal, and with capital divisible into transferable shares."[66] As a separate legal person a company has certain powers 'necessarily and inseparably incident to every corporation' such as the power to conclude contracts.[67] Owing to the doctrine of limited liability, the transactions of a share company create legal rights and obligations vested in the company itself as opposed to its members. Since a company is a separate legal person with property interests, it will alone be liable for the debts it incurs.

[66]Gogna, P.P.S (2004), *A Textbook of Company Law,* (New Delhi: S. Chand & Company Ltd.), P.9[Herein after, Gogna, A Textbook of Company Law] as cited in Endalew Lijalem, The doctrine of piercing the corporate veil: its legal significance and practical application in Ethiopia, *Mizan Law Review*, 2012, Vol. 6, No.1, PP. 77-114, 2012, at P.98 -101[Herein after, Endalew Lijalem, The doctrine of piercing the corporate veil]

[67] J.L. Stewart and M.L. Palmer, *Company Law of Canada*, 1962, (Toronto: The Cars well Company Ltd, 5thed.) P. 46, as cited in Seyoum Yohannes Tesfay, on Formation of Share Companies in Ethiopia, PP. 102-127, at P. 104[Herein after, Seyoum Yohannes, on Formation of Share Companies]

This means that, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their private funds.[68]

Limited liability allows for 'risk sharing' between the owners[69] of the company and the outside parties with whom the company interacts and if the company fails, the effect of the doctrine is that losses are partly externalized – they fall upon external creditors.[70] Although this is generally seen as acceptable in the ordinary course of commerce, where incorporated businesses benefit from reciprocal risk transfers, it proves to be far less palatable where the costs of business failure fall upon tort claimants. This is because, at the outset of their relationship with the company, creditors can contract[71] for an adequate interest rate, possibly, for control rights on the company,[72] and ask for additional securities from the company.[73] Moreover, recently, under the current conditions of economic recession, creditors also ask for personal securities of shareholders for the obligations of the company. In such cases, creditors 'contract out of the doctrine of limited liability'.[74]

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[68] Dine Janet and Koutsias Marios, *Company Law*, 2007, 6th ed., London: Palgrave Macmilan, P.2 as cited by Endalew Lijalem, The doctrine of piercing the corporate veil: Its Legal and Practical Significance in Ethiopia, P. 82

[69] As defined by Business Directory. Com, a shareholder is "an individual, group, or organization that owns one or more shares in a company, and in whose name the share certificate is issued." Hence, owners of a corporation are called shareholders or stockholders. See Tiffany C. Wright, Is the Owner of a Corporation Considered a Shareholder?, at <yourbusiness.azcentral.com/owner-corporation-consider-12510.html>[last accessed March 24, 2017]; Shareholders are also considered to be the ultimate owners of a corporation because they have the right to elect directors, vote on major corporate actions (such as mergers) and share in the profits of the corporation. See also Owners of a Corporation, at <https://www.legalzoom.com/knowledge/corporation/topic/corporation-owners>[last accessed March 24, 2017]; As defined by Investopedia, a shareholder is any person, company or other institution that owns at least one share of a company's stock. Because shareholders are a company's owners, they reap the benefits of the company's success in the form of increased stock valuation. If the company does poorly, however, shareholders can lose money if the price of its stock declines. See also What is a 'Shareholder', at<www.investopedia.com/terms/s//shareholder.asp> [last accessed March 24, 2017]

[70] Contractual Creditors refers only to voluntary creditors (i.e. all of the creditors who contracted with the company at their own will).See also Olga Petroševičienė, Effective Protection of Creditors' Interests in Private Companies: Obligatory Minimum Capital Rules Versus Contractual and Other Ex Post Mechanisms, *Social Sciences Studies,* 2010, Vol. 3, No. 7, PP. 213-228, at P.221

[71] Luca Enriques and Jonathan R. Macey, 'Creditors Versus Capital Formation: The Case against the European Legal Capital Rules, *Cornell Law Review*, 2001, Vol. 86, No. 1165, PP. 1168 and ff, at P. 6. <http://scholarship.law.cornell.edu/clr/vol86/iss6/>. [Herein after, Luca Enriques et al, Creditors Versus Capital Formation] See also Barry E. Adler and Marcel Kahan, The Technology of Creditor Protection, *University of Pennsylvania Law Review*, 2013, Vol. 161, No. 7, PP. 1773-1814, at P. 1778.

[72] For instance, a debtor is usually not entitled to invest, purchase or acquire assets of a particular value, to borrow or to lend particular sums, to mortgage or pledge real property, etc. without a prior written consent of the creditors. See Id, P. 221.

[73]The securities may include real estate mortgage, pledge, bank guarantee, etc. See Ibid.

[74] Machado, F. S. *Mandatory Minimum Capital Rules or Ex Post Mechanisms*?, P.28 at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568731 [last accessed April 6, 2017]

On the other hand, the company law protected the interest of shareholders of a company through the application of the doctrine of limited liability (save in exceptional cases) which, among others, shifts some of the costs of innovation and its failures to the creditors and employees of companies.[75] Limited liability is one of the major attractions of the corporate forms which permit those who invest in an incorporated business to limit potential losses.[76]Be that as it may, tort claimants are, however, unlikely to have opportunities to deal with the company that injures them.[77]

Most of the damages to tort creditors arise due to Changes in technology, knowledge, liability rules, and procedures for mass tort litigation have for the first time raised the prospect of tort claims that exceed the net worth of even very large corporations.[78] Environmental harms, such as oil spills or the release of toxic materials, are one potential source of massive liability; hazardous products and carcinogens in the workplace are others.[79]It is, thus, held that shareholders can no longer always be assumed to be passive investors. Indeed, they might prove pivotal in business decision-making.

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[75]L.C. Backer, *Comparative Corporate Law*, Op cit, 995 as cited by Seyoum Yohannes, on Formation of Share Companies, P. 105

[76] Christian Witting, Liability for Corporate Wrongs, P. 113.

[77]Ben-Ishai et al.,, Involuntary Creditors and Corporate Bankruptcy, P. 257; It is argumentative whether the so-called 'involuntary creditors' excludes employees, consumers, trade creditors, and lenders. See Easterbrook et al., Limited Liability and The Corporation, P. 89

[78]Henry Hansmann et al., Toward Unlimited Shareholder Liability for Corporate Tort, P. 1880

[79] Ibid; Kumar, 'Mega hazards': The New Threat P. 448

2.2. Limited Liability and the Attributes of Separate Legal Personality in Ethiopia

Under Ethiopian Commercial Law there are two types of companies,[80] namely Share Company and Private Limited Company.[81] In both types of companies legal personality is acquired by fulfilling the various requirements of the Commercial Code of Ethiopia.[82] Due to its separate legal personality, a company is a subject of rights and obligations, in its own right, distinct and separate from its shareholders, directors and managers. It may therefore, enter into any kind of juridical acts such as contracts.[83]

Besides, the commercial code incorporated the doctrine of limited liability for both types of companies'.[84]Since a company is a separate person with property interests, it will alone be liable for the debts it incurs. This means that, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their private funds. The shareholders are liable only to the extent of the amount they have paid, or have promised to pay, for their shares.[85] Hence, a company is responsible for its own actions and will be predominantly liable for its own debts and the company's creditors cannot seek the satisfaction of their claims from the members even if the company's funds (assets) are insufficient to pay its liabilities in full. Moreover, the personal creditors of shareholders have no right to the company's assets except to the extent of the debtor member's share.[86]

[80] While the term 'Company' is used in the Ethiopian legal system, the term 'Corporation' is commonly used in the common law legal system though it is broader in concept which includes public enterprises. Since the doctrine of piercing the corporate veil is of common law origin, the term corporation is seldom used in this article particularly in sections dealing about foreign laws and not to confuse it with the term company. However, the term company is exclusively used in the sections dealing with the legal and judicial recognition of the doctrine in Ethiopia. See also Shittu A. Bello1 and Ogwezzy C. Michael, *Review of Contemporary Business Research*, 2014, Vol. 3, No. 2, PP. 117-138, at P. 118 & 119

[81] Commercial Code, Article 510. A private limited company is a company consisting of two to fifty members who are liable only to the extent of their contribution. It is always commercial in form and governed by the Commercial Code provisions of Arts. 510- 543 and the general provisions applicable to all forms of business organizations (Arts. 210- 226).

[82] Commercial Code, Articles 223, 323, 324.

[83]Seyoum Yohanness, On formation of Share Companies, P. 104

[84] Commercial Code, Articles 304 and 510.
[85] Luca Enriques et al, Creditors Versus Capital Formation, P. 2
[86]Chon E. J and Simitis C., 'Lifting the veil in the company laws of the European continent', *International and Comparative Law Quarterly*, 1963, Vol. 12, No. 1, P.189.

However, it must be noted that the law does not prevent the companies from making the liability of its members unlimited through the express provisions in the articles of association.[87] The rule of limited liability has a general application. It applies to all companies regardless of the number of shareholders, the type of business, or even whether they have business operations at all or merely function as a shareholding parent within a corporate group.[88] Share companies and private limited companies differ from other forms of business organizations in that the latter do not enjoy limited liability except those who are limited partners in limited partnerships.[89] This attribute of a company has greatly facilitated the expansion of business, particularly in the risky ventures. This is because limited liability encourages greater risk-taking in the business community, so that new avenues of commerce are explored, and this enhances employment (P. 84) opportunities, the nation's economic and financial growth, stability and prosperity.[90] Since the liability of the shareholders (members) is limited to their contribution, the company's creditors cannot extend their hands to the personal property of the shareholders.

As addressed by Nigussie Taddesse[91] although limited liability is an advantage for shareholders, it may, however, greatly affect the interest of creditors mainly that of tort creditors in different ways such as: Shareholders who employ the company's name through which to contract with others may misrepresent the assets of the company and simply walk away if the business fails,[92] engage in asset diversion for example via making distributions to themselves in the form of dividend payments, share buy-backs, and

[87]Bagrial Ashok K. (2007), *Company Law*, 12th ed., New York, Vikas Publishing House Pvt. Ltd., P. 34. This is particularly true in case of companies limited by guarantee where the shareholders agreed to guarantee the debts of the company to a certain extent beyond their contribution, in case the company becomes unable to meet its debts. This possibility is not also totally closed even under Ethiopian law. This is because there is no clear prohibition from making the liabilities of shareholders unlimited through their mutual agreement (for the benefit of third party creditors). However, in case of General Partnership, it is not possible to make the liabilities of partners limited by their article of association as the provision of the law is mandatory.

[88]Cheng Thomas K., 'Form and substance of the doctrine of piercing the corporate veil', *Mississippi Law Journal*, 2010, Vol. 80, No. 2, P. 510.

[89]Commercial Code, *supra* note 17, Arts. 255 (2), 280, 296.
[90]Jesse H. Choper, Jhon C. coffee and Robert Morris Jr. (1989), *Cases and materials on corporations,*3rd ed., Case Book Series, (Canada: Little Brown and Company Ltd.), P. 145

[91]Nigusie Tadesse, *Major Problems Associated with Private Limited Companies in Ethiopia: the Law and Practice,* 2009,LLM, senior Thesis, Addis Ababa University, Law faculty, [unpublished available at law library], P. 147-156[Herein after, Nigusie Tadesse, Major Problems Associated with Private Limited Companies in Ethiopia: the Law and Practice]
[92] Allen William T., Kraakman Reinier, and Subramanian, *Commentaries and cases on the law of business organizations,2007,* 2nd ed., New York: Aspen publishers, P. 131; See also Nina A. Mendelson, A Control-Based Approach to Shareholder Liability, P. 1203.

excessive salaries, engage in claim dilution by issuing additional debt of the same or higher priority,[93] or more subtly, shareholders or directors may undertake highly risky (volatile) investments or increase leverage in order to shift uncompensated risk onto the shoulders of creditors.[94] Similarly, Endalew Lijalem[95] addressed the possibilities for shareholders of companies to engaging in a different illegal activities such as fraud thereby affecting the interests of creditors.

Moreover, Tamiru Alemayehu,[96]Selamawit Kifle,[97]Tesfay Aregawi,[98]Arega Shumetie Ademe and Molla Alemayehu[99] and Anmaw Demis[100] studied that the concentration of chemical constituents are presumed to have been released from both domestic and industrial activities increase downstream and the high abundance of such chemical constituents that do not concentrate naturally is strong evidence of water (which may serve for various purposes such as horticulture, drinking water for cattle, washing and for other domestic activities) pollution by industrial wastes. These pollutions are causing different health problems. These are really the major grounds that give rise to the liability of companies (industries) to the tort victims and to shareholders if the company fails to meet its tort liabilities.

Despite the existence and or potential existence of the above problems, the Ethiopian laws do not provide for a strict liability of shareholders or members by mere fact that they have assumed the status of shareholders even if they drive arbitrary gains resulting from those actions deliberately undertaken in their behalf.

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[93]Sollars, An Appraisal of Shareholder Proportional Liability for Corporate Torts, P. 329; see also Nigusie Tadessie, Major Problems Associated with Private Limited Companies in Ethiopia, P. 147- 156

[94] Ibid.

[95]Endalew Lijalem, the doctrine of piercing the corporate veil: Its Legal and Practical Significance in Ethiopia, P. 98-101

[96]Tamiru, The Impact of Uncontrolled Waste Disposal on Surface Water Quality in Addis Ababa, P. 93-104

[97]Selamawit, Industrial Waste and Urban Communities in Addis Ababa: The Case of Akaki Kaliti and Kolfe Keranio Sub Cities, P. 21

[98]Tesfay, Peculiar Health Problems Due to Industrial Wastes in Addis Ababa City: the Case of Akaki Kality Industrial Zone, P. 29

[99]Arega Shumetie et al, Source and Determinants of Water Pollution in Ethiopia, P. 2

[100]Animaw, Corporate Social Responsibility in Ethiopia: Case Study of Bahir Dar and Habesha Leather Factories, P. 64

2.3. The Notion of Shareholders Liability for Company's Torts in Ethiopia

The Commercial Code of Ethiopia provides that "a private limited company is a Company whose members are liable only to the extent of their contributions."[101] Although the Commercial Code provides for the liability of members instead of first providing for corporate liability, it is obvious that the corporate liability of a private limited company is limited to its assets. Similarly, the Commercial Code provides that the liabilities of a share company are limited to the total value of its assets.[102]Assets are the sum total of what a company owns.[103]The total initial contribution from members (i.e. the sum total of the par value of all shares issued) constitutes the capital of a company.[104]

The amount contributed by shareholders in excess of the par value (face or nominal value) of the share is known as issue premium[105]and is not part of the capital but is still part of the *assets* of a company.[106] The other components of the assets of a company, particularly a share company, are the various types of reserves created from the profits generated by the company itself. Reserves may take different forms, namely, legal reserve, supplementary reserve, optional reserve and free reserve depending on the source that created them.[107]All these constitute assets of the company against which creditors may proceed for the satisfaction of their claims and no shareholder is personally liable so long as she/he has made her/his promised contribution. That is, once the shareholder has paid the par value and any premium agreed, s/he is no longer liable to contribute anything further towards meeting the company's debts and liabilities. Below are the grounds of shareholders liability under the Ethiopian Commercial code.

2.3.1. Liability Rules under the Law of Bankruptcy

One of the most serious attempts to safeguard the interest of corporate creditors is provided by the statutory obligations placed upon certain persons in respect of their potential personal liability for the

[101] Commercial Code, Article 510 (1)
[102]Ibid, Article 304 (1)
[103]Seyoum Yohanness, On Formation of Share Companies, P.106
[104] Commercial Code, Article 306 and 512
[105]Shares can be classified as share at discount and shares at premium based on the price at which shares are issued. Shares at discount are shares issued at a price lower than its par (face) value. However, under Ethiopian law share at discount are totally prohibited. On the other hand, premium shares are shares issued at a price greater than the par value where such issue is provided by the memorandum or article of association or decided by an extraordinary general meeting. The difference between the par value and the price at which the shares are issued shall be known as a premium. See Commercial Code, Article 326.

[106]Seyoum Yohanness, On Formation of Share Companies, P.106.
[107]Commercial Code, Article 453 (2(d)).

debts and liabilities of the company, following the company's slide into a state of bankruptcy. The following two provisions are relevant in this regard.[108]

With respect to Private Limited Companies, the Commercial Code renders persons who participated in the management of the company that has become bankrupt liable for the debts of the company unless they rebut the presumption of non-diligence by proving that "they have acted with due care and diligence."[109]It also provides that "if a private limited company becomes bankrupt and as a result the assets are shown to be inadequate, the court may order the managers or members or both to pay the whole or part of the company's debts separately or jointly."[110] The terms 'managers' and 'members' under this provision respectively refer to non-member managers and member managers; or members who have acted as managers (though not managers *per se*). This can be understood from the words of Article 531 (2) of the same code which stipulates that "the liability shall not apply to members who have not acted as mangers" (non-manager members). Therefore, the application of Article 531 of the Commercial Code is restricted only to persons (be they members or non-members) who are managers or who acted as managers of a company. Thus, it is not possible to make all members of the private limited company *per se* liable during the event of its bankruptcy.

The logical question that may follow is, as to whether the liability applies when the assets of a private limited company are shown to be inadequate though it is not declared bankrupt. That is, whether judicial bankruptcy (insolvency (factual bankruptcy)) is the requirement. One may logically argue that the liability can also apply in this case though the private limited company is not declared bankrupt.

Generally, if the company becomes unable to meet its debt, the law takes a presumption that the manager(s) were not diligent or careful in their management. However, the presumption is rebuttable and hence such persons can escape from liability by proving that they have acted with due care and diligence.[111]

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[108] Id, Article 531 and 1160 (1)
[109] Id, Article 531
[110] Id, Article 531(1)
[111]Id, Article 531(2)

Similarly, the Commercial Code makes certain persons liable for the debts of the company if it becomes bankrupt.[112]It states that "Where a share company or private limited company is declared bankrupt, the adjudication may declare bankrupt any person who has carried out commercial operations on 'his own behalf'[113] and disposed of 'company funds'[114] as though they were his own and concealed his activities under the cover of such company."[115]

Therefore, if a share company or private limited company is declared bankrupt,[116] creditors can require the bankruptcy of 'any person' who has carried out the operations in the manner stated in the provision. Although Ethiopian law extends such liability to 'any person' subject to the fulfillment of the conditions stipulated by the law, it does not expressly indicate as to who these persons are. Under such situations, the Uniform Acts of the Organization for the Harmonization of Business Law in Africa (OHADA) provide for personal bankruptcy of natural persons who are managers or representatives of body corporate whether they are de jure, de facto, remunerated or not, apparent or hidden.[117] Ethiopian law has no clear provision indicating who these persons are, and seems to extend the bankruptcy to 'any person' (irrespective of whether they are managers or not).[118] Although as a matter of rule, bankruptcy applies only to traders and commercial business organizations[119]under Ethiopian law, Art. 1160(1) seems an exception to this general rule. Hence, the phrase "any person" in Article 1160(1) of the Commercial Code refers to "any person" (both natural and juristic), irrespective of whether they are managers, directors or

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[112]In this case the provision applies to both share and private limited companies. See Id, Article 1160

[113] The phrase 'On his own behalf' means that the person carried out the business in his personal interest or benefit, or the person has some pecuniary or non-pecuniary interests directly or indirectly accruing to him. See Seifu Teklemariam, *Piercing the corporate veil: its application to private limited companies and share companies in Ethiopia*, Senior Thesis, Faculty of Law, Haile Selassie I University, (unpublished), 1968,P.24.

[114]Although it is not clear as to what the phrase 'company's funds' refers to, it is logical to understand that it should not be limited to imply the company's liquid money but rather it includes all properties constituting the company's assets. See Endalew Lijalem, Piercing the Corporate Veil: Its Legal and Practical Significance in Ethiopia, P. 100

[115]Commercial Code, Article 1160(1).

[116]Ibid, Article 968. A company is said to be bankrupt, it must have suspended payments and declared bankrupt by the court of law as factual bankruptcy cannot be taken as a ground.

[117] The Organization for the Harmonization of Business Law in Africa (OHADA), *Uniform Act Organizing Collective Proceedings for Wiping off Debts,* Article 194

[118]Endalew Lijalem, Piercing the Corporate Veil: Its Legal and Practical Significance in Ethiopia, P. 100

[119]The subjects of the bankruptcy proceeding are traders and Commercial business organizations. It has, however, to be noted that the person (to be considered as a trader) should carry on one or more of those activities professionally and for the purpose of earning profit out of such activity to be taken as a trader. See Commercial Code, Articles 5, and 968 *cum*. 1155.

not, regardless of whether they are traders or not so long as the conditions stipulated by law are fulfilled.[120]

It is to be noted that creditors of a bankrupt private limited company have a dual option to exercise their claim. First, they can base their claim on Art. 531 of the Commercial Code and proceed against managers or persons that participated in the management of the company without the need to extend bankruptcy proceeding of the company to the manager. This is because the creditors shall not have the burden of proving that the manager(s) were not diligent or careful in their administration of the company since the law makes a presumption of non-diligence. Moreover, the conditions of Article 1160 need not be proved by the creditor in bankruptcy. For creditors of private limited company this is a preferable action, if the manager could be able to meet the claim. Secondly, if it is not possible to recover the debts from managers according to Article 531, they may require the court to extend the bankruptcy to such persons as per Article 1160(1) of the Commercial Code upon the burden of proving the conditions required by law.

Thus, in the above situations it is clear that the Ethiopian Commercial law does not address for the liability of shareholders if they do not participate in the circumstances so mentioned. Thus, the members can be liable if and only if they committed fault by engaging in the conditions prohibited by the law. Moreover, the number of those persons who are involved in the management is very few compared to non manager members and hence it is unthinkable that they will adequately satisfy the claims of tort creditors.[121]

2.3.2. Liabilities of Founders (Assuming that they Become Shareholders) for the Faults Committed During the Formation of a Company

Before a share company can be formed, there must be some persons who have an intention to form a share company and who take the necessary steps to carry that intention into operation. Such persons are called founders. The word ‘founder’ has not been defined anywhere in the commercial code.

[120] Ibid.

[121] Fekadu Petros Gebremeskel, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *Mizan Law Review*, 2010, Vol. 4 No.1, P. 2 [Hereinafter, Fekadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications]

The founder is a person who brings a share company into existence. He/she is one who undertakes to form a share company with reference to a given object and to set it going and who takes the necessary steps to accomplish that purpose. The founders decide the scope and business of the share company. They prepare the necessary documents. They make arrangements for advertising and circulating the prospectus.

Share Company may have several founders. A founder may be an individual or body corporate. One existing body corporate may be founder of new share company. A person who is not member of the newly formed share company, but acts in a professional activity for the founding of the company is also founders of the share company.

Founder under the Ethiopian Commercial Code are: persons who sign the memorandum of association and subscribe the whole of the capital or; where the company is formed by issuing shares to the public, founders are persons who sign the prospectus, bring in contribution in kind persons who are allocated special shares in the profit or; any person outside of the company who initiated the plans of facilitating the formation of the company.[122]

The nature of the founders work in the formation of the share company call for the considerable skill for which he should be paid a share which shall not exceed one fifth of the net profits in the balance sheet.[123]Such amount must be stated in memorandum of association. In the absence of such statement, a founder has no right against the company for his payment. If it is stated, it is presumed that there is a contract which gives the directors power to pay the preliminary expenses out of the company's funds. Such benefit may not extend for more than three years and the founders have no any other right than the one stated in this paragraph.

As to the exact position of the founders the code is silent. They are not agents because there is no principal. However, founders from the moment they start to act with the name of the company they stand in a fiduciary position towards the share company under formation. They have the power of creating and modifying the company. They may enter into commitments with third parties in the name of the company,

[122] Commercial Code, Article 307 (1-3)
[123] Id, Article 310

but they may be refunded after the company has taken over this commitments and the company may only take over if the commitments taken by the founders were necessary for the formation of the company.[124]

As for liabilities of the founders the law does not state for the transfer of such liabilities.[125]The violation of those acts may lead into the violation of stated provision and this in turn may result into criminal liability and criminal liability is borne by the doer personally not to be transferred to third party. If the required capital and subscription is not fulfilled[126]it is violation of law. For example, the minimum capital required to form Share Company with less than stated amount will result in violation of the law. Similarly, the capital of Share Company should be fully subscribed upon formation. If founders formed share company without fully subscribed, such will lead to the violation of the law. As to the contribution in kind, it must be done by an expert (Art 315), and be verified. If the amount does not conform to exact value then there is violation of the law by the founders. The same is true if false prospectus is advertised.

It is clear that the Ethiopian Commercial law does not address for the liability of founders (assuming that they later become members of the a company) by mere fact that they are members if they do not engage in the commitments which are not valid in the eyes of the law or the one that can be approved by the general meeting of subscribers. Thus, the founders can be liable if and only if they committed fault by engaging in the conditions prohibited by the law. Moreover, it also seems logical to argue that the number of founders is very few and hence it is unthinkable that they will adequately satisfy the claims of tort creditors since mass tort claims exceed the assets of even very large corporation.

2.4. The Position of Unsecured Creditors during Bankruptcy in Ethiopia

It is an underlying principle that the unsecured creditors are entitled to a dividend proportionate to their respective claims *(pari pasu)*. As you know unsecured creditors are those creditors who held nothing in security that guarantee performance of the obligations by the debtor. The overall objective of the bankruptcy proceeding is to collect the properties of the debtor and realize them for the satisfaction of the claim of creditors. In the process, those creditors who are secured

[124] Id, Article 308 (2)
[125] Id, Article 309 (1)
[126] Id, Article 309 (1(a))

would satisfy their claims from the property at their hand. As a result, it is the unsecured creditors who compete to get a certain share from the proceeds of sale of the properties of the debtor. In the process of distribution, each of the unsecured creditors could not get what he claimed. Rather the proceeds of sale, after certain expenses such as administration costs and the costs of carrying out the bankruptcy proceeding are deducted, would be distributed among the unsecured creditors based up on their claims.[127]

The principle of proportionate *(pari pasu)* distribution applies only in relation to unsecured creditors who acquired a right before the declaration of bankruptcy. It should be noted that, it is pre-liquidation rights that are to be respected. Those creditors who become creditors as the result of contract entered into by the trustee/liquidator are entitled to have their claims treated as expenses of the bankruptcy process and paid out of the assets in priority even to the claims of preferential creditors. The rationale behind such a priority is that to enable the trustee/liquidator or the commissioners obtain goods or services during the bankruptcy process. Where there is no such a distinct right the bankruptcy proceeding would not be carried out properly and speedily. No one would be willing to enter into transactions with a person or the representative of a person who is already declared bankrupt. But where one knows that he will be entitled to priority right in the distribution and not to compete for proportionate but full payment of his claims, then he would be encouraged to enter into transactions that can facilitate the bankruptcy process.

Even pre-liquidation creditors will be able to jump the queue where the trustee is dependent on their continuing to supply goods or services and they make it a condition that existing debts must first be paid. In such a case, the liquidator is entitled to pay the pre-liquidation claims in question as being expenses of the liquidation necessary to preserve the debtor's business or its other assets.

Thus, while one of the mechanisms of protection of tort creditors was being prioritizing their claims in the secured credit systems, [128] let alone holding shareholders liable for the wrongs committed by their

[127]Id, Article 1110

[128] Christopher M. E. Painter, Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times, *Stanford Law Review*, 1984, Vol. 36, No. 4, PP. 1045-1085, at P.1076

companies, the Ethiopian Commercial law does not even prioritize the claims of tort creditors on the winding up of the company in the bankruptcy proceeding.[129]

2.5. Environment Related Rules for the Liability of Shareholders for Company Torts

2.5.1. Liability Rules under Constitutional Law

From the very reading of the FDRE Constitution we can infer the fact that all Federal and State legislative, executive and judicial organs at all levels shall have the responsibility and duty to respect and enforce the right to live in a clean and healthy environment.[130]Furthermore, it clearly stipulates that the government has the duty to hold, on behalf of the people, land and other natural resources and to deploy them for their common benefit and development.[131] In line with the above stipulations, the FDRE Constitution clearly spelt out that the government shall endeavor to ensure that all Ethiopians live in a clean and healthy environment; and that government and citizens have the duty to protect the environment.[132] To bring about the legal penetration of the above responsibilities on the government and citizens on to ground, the FDRE Constitution ensures that the door is wide open for the public interest groups to safeguard the environment from potential or actual damage to the environment.[133]

Having the above substantive and procedural laws, the FDRE Constitution stipulates that in case when any state program affects the interest of any person, the interested party or any public interest group could demand adequate, prompt and effective compensation as a legal remedy.[134]As to the realization of this right, the court of law which entertains the case would be expected to take judicial notice of the legal provisions in the enabling legislations.

[129] Commercial Code, Article 1110

[130] The Federal Democratic Republic of Ethiopia Constitution, 1995, *Negarit Gazette*, 1st Year, No. 1, Art. 13. [Herein after, FDRE Constitution]

[131] Id, Article 89(5) and 91(2)

[132] Id, Article 91

[133]Id, Article 37(2)(b)

[134]Id, Article 44(2)

It seems, therefore, that it is against the state that the victims demand compensation for the damage they incurred in relation to the state programs that affect the healthy environment. The liability does not, thus, extend to shareholders by mere fact that they enjoy arbitrary gains resulting from actions deliberately taken in their behalf. Moreover, it does not raise as such serious questions in case of damages arising out of state programs since in this case; the program is more likely to be undertaken at majority of instances for public purposes. The concern would rather be on the liability of shareholders since the very purpose of buying shares being driving benefit from the investments undertaken by the companies on behalf of them. This is because while the benefits derived by shareholders is not limited to those benefits derived from investments that does not affect tort claimants, their liability is limited to the amount of their shares.

2.5.2. Liability Rules under Administrative Laws

According to Proclamation No 295/2002, the objective of the Environmental Protection Authority is to formulate policies, strategies, laws, and standards, which foster social and economic development in a manner that enhances the welfare of humans and the safety of the environment, and to spearhead in ensuring the effectiveness of the process of their implementation.[135] To realize this objective the proclamation empowers the Authority, inter alia, to coordinate measures to ensure that the environmental objectives provided under the constitution and the basic principles set out in the environmental policy of Ethiopia are realized.[136]

In line with the above stipulation, Proclamation No 300/2002 reiterates that the Authority or the relevant Regional environmental agency may take administrative or legal measures against a person who, in violation of law, releases any pollutant to the environment.[137]The provision is indicative in that the Authority or the relevant regional environmental authority can take administrative or legal remedies proactively or reactively in case when there is actual or potential damage to the environment. The administrative and legal measures could entail among other things installation of sound technology, recycling of waste, cleaning up or payment of the cost of cleaning up the polluted environment, and any measure up to the closure or relocation of any enterprise in order to prevent harm if the activity poses a

[135]Environmental Protection Organs Establishment Proclamation, Procl. No. 295/2002, Neg. Gaz., 9th Year, No.7, Article 5[Herein after, Procl. No. 295/2002]

[136] Id, Article 6

[137] Id, Article 3

risk to human health or to the environment.[138]In line with the above stipulation, the Proclamation provides that protection and safeguarding of the environment is the responsibility of both the government, and each and every citizen, so much so that in case when there is positive steps by alert citizens to install sound technologies to avert pollution it is a must case for the government to supplement such efforts at least by exempting these parties from paying custom duty.[139]

We can deduce from the above discussion that administrative remedies do not go to the extent of making shareholders of the polluting company (the company that causes damage to the tort creditors) strictly liable for the damage caused to tort creditors since they drive arbitrary gains from such damaging investments.

2.5.3. Liability Rules under the Civil Code

Torts Law is fashioned as an instrument for making people adhere to standards of reasonable behavior and respect the rights and interests of one another. Thus, it does this by protecting the legal interests and by providing compensation for the loss suffered by him from the person who has violated the same. Therefore, to constitute a tort or civil injury; there must be a wrongful act committed by a person; the wrong act must give rise to legal damage or actual damage; and the wrongful act must be of such a nature as to give rise to a legal remedy in the form of an action for damages.

In Environmental Law, liability for a tort arises when a wrongful act complained of amounts either to an infringement of a legal private right or a breach or violation of a legal duty. That is, when there is public or private nuisance.[140] The word 'nuisance' is derived from the French word 'nuire' which means "to hurt or to annoy".[141] Blackstone described nuisance as something that "worketh hurt, inconvenience or damage".[142]At this juncture it is important to know that nuisance is of two kinds. These are:

[138] Ibid.
[139] Id., Art. 10
[140]Tsegai Berhane and Merhatbeb Teklemedhn, Environmental Law Teaching Material, Mekelle University Faculty of Law, Prepared under the Sponsorship of the Justice and Legal System Research Institute, 2009, P. PP. 1-189, 167
[141] Ibid.
[142] Ibid.

2.5.3.1. Public (Common) and Private Nuisance

Public nuisance is an act affecting the public at large or considerable portion of it; and it must interfere with the rights which members of the community might otherwise enjoy.[143] Acts, which seriously interfere with the health, safety, comfort or convenience of the public generally, which tend to degrade public interest have always been considered as public nuisance.[144] The basis of the law of nuisance is the maxim 'sic utere tuoutalienum non laed as': which means that 'a man must not make such use of his property as unreasonably and unnecessarily to cause inconvenience to his neighbors'.[145]In order that an individual to have a private right of action in respect of a public nuisance he must show: a particular injury to himself beyond that which is suffered by the rest of the public; such injury must be direct and not mere consequential injury; the injury must be of substantial character, not fleeting or evanescent.[146] Therefore, in order to entitle a person to maintain an action for damage caused by that which is a public nuisance, the damage must be particular, direct and substantial. This is true in case when the plaintiff manages to get redress only to his personal injury via the traditional litigation. Under our legal system, this could be entertained on the basis of Article 33(2) of the Civil Procedure Code and Article 2091 of the Civil Code.

However, in case of public nuisance, on the basis of Article 37(2) (b) of the FDRE Constitution and Article 11 of Pollution Control Proclamation, if the case is initiated by public spirited individual or public interest groups in case when there is actual or potential damage to the environment and when the damage is so diffused, it is not a prerequisite to show that they have vested interest to get standing before the court of law.

Private nuisance is using or authorizing the use of one's property or of anything under one's control so as to injuriously affect an owner or occupier of property by physically injuring his property or by interfering materially with his health, comfort or convenience.[147] Private Nuisance includes acts leading to**:** Wrongful disturbances of easements or servitude, e.g. obstruction to light and air, disturbances of right to support;

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[143] Ibid.
[144] Ibid.
[145] Ibid.
[146] Id, 167 and 168
[147] Id, P. 168

and Wrongful escape of deleterious substances into another's property, such as smoke, smell, fumes, gas, noise, water, filth, heat, electricity, disease causing germs, trees, vegetation, animals etc.[148]

2.5.3.2. Persons Liable for Nuisance

It is a general principle that an action for nuisance must be brought against the hand committing the injury, or against the owner for whom the act was done.[149] An action for nuisance will lie against the person; if he causes it; if by neglect of some duty he allowed it to arise; and when it has arisen, without his own act or default, he omits to remedy it within a reasonable time after he became or ought to have become aware of it.[150] The remedies for nuisance are: abatement, damages and injunction.[151]

When we look at the Ethiopian legal system in line with the above principles, the torts law, provides civil remedies for personal injury and their property. According to this instrument[152]the damage due by the person legally declared to be liable shall be equal to the damage caused to the victim by the act giving rise to the liability. The grounds of liability under the tort law are provided below.

2.5.3.2.1. Liability for Dangerous Activities or Creation of Abnormal Risks

The Ethiopian Commercial code provides for the liability of a person who undertakes dangerous activities or creates abnormal risks. The activities include: storing or using explosives or poisonous substances; establishing high-tension electric transmission lines; modifying the natural lie of the land; and engaging in exceptionally dangerous industrial activities.[153]These activities are economic activities and they have advantages to the community. Thus we cannot prohibit them. At the same time we have to protect the public and individuals from hazardous activities that cause damage. Thus, the owners are liable without

[148] Id, P. 168 and 169
[149] Id, P. 169
[150] Ibid.
[151] Ibid.
[152] Civil Code of the Empire of Ethiopia, 1960, *Negarit Gazette*, 19th Year, No 2, Article 2091[Herein after, Civil Code]
[153]Id, Article 2069

the victim establishing fault for it would be unreasonable to expect the victim to establish fault,[154] which is very difficult. The law rather requires those who engage in those activities to establish fault from the side of the victim thereby shifting the burden of proof to those who engage in those kinds of activities. They do that by proving the victim is at fault fully or partly.[155]The reason why the law takes this position seems that the giant corporations engaged in those activities are powerful in every aspect when compared with the victim. Moreover, they are the beneficiaries of the activities. Finally, yet importantly, they are in a position to distribute the loss among the community by adding the compensation they paid to the victim by adding it on the value of the products they produce. The law also devices a mechanism to protect those who engaged in those activities by stating that engaging in those activities by itself does not make those who engage in those activities liable. They shall be liable where the danger they have created materializes thereby causing damage to another. [156]

A person could store or use explosives or poisonous substances. For instance, a farmer could use pesticide, which could be washed in to a river where people and animals use that river for drink. If people drink from that water and consequently became sick the farmer shall be liable. What about animals? Ethiopian Electric and Power Corporation (EEPC) erect high tensioned electric transmission lines to supply powers to different parts of the country. EEPC does not allow people to build houses beneath or around those high tensioned lines for either in the end people could develop skin cancer or if those lines fall the danger they create is disastrous. Thus, if that materializes EEPC shall be liable. Constructing canals, dams, highways, etc. are important. At the same time, these activities could expose people to damages. For instance, if dams burst and flooded a village killing people those who run the dams are liable.

Some of the industrial activities listed as dangerous by Ministry of Labor and Social Affairs are Chemical Industries, Cement and Asbestosis, Coal mining, etc.[157]So, where these dangerous industrial activities cause damage to people the owners shall be liable. Two points deserve brief mentioning. Sub article (1) of article 2069 regulates a condition where these activities cause damage to persons, i.e. human beings. The damage could be injury or death. Whatever is the consequence liability follows provided the

[154] Richard Kinder, *Case Book on Torts*, 7th ed., Oxford University Press, Oxford, New York, 2002, P. 312
[155] Civil Code, Article 2086 (2)
[156] Id, Article 2069 (1)
[157] Occupational Health and Safety Training package, Ministry of Labor and Social affairs, Addis Ababa, May 1997(Unpublished)

activities are causes for the damage. When the damage is related to property, however, as a matter of principle the property has to be completely destroyed to make the owner of the industries liable. The reduction in value may not be reason to make the one who engage in those activities liable provided she or a person whom she is responsible for has not committed fault as sub article 2 of article 2069.

Thus, it can be understood that the Ethiopian Civil Code provides only for the liability of the company (if it acts against what the law provides) itself without saying anything about the liability of the members of the Company. The Civil Code does not extend such liability to the shareholders or members of the company.

2.5.3.2.2. Liability for Manufactured Goods

A person who manufactures goods and sells to the public for profit shall be liable for any damage to another person resulting from the normal use of goods.[158]There are elements worth discussing. The first element is the phrase "a person …"The phrase could be either physical or natural person. The second element is the phrase "…who manufactures goods…" Under common legal system manufacture goods are referred to as "Manufactured products"[159] Examples for "manufactured products are cars, radios and computers."[160] From these examples we can understand that manufactured products do not simply refer to food and drinks as some think. "It has been held to cover motor vehicles, lifts, clothes, cleaning fluids and building".[161]Under our law, however a building may not be classified as manufactured products.[162] The third element is the phrase "…Sells to the public for profit…" To start with, if someone gives a manufactured product for donation and the donee is injured this article may not be applicable. Furthermore, if two individuals exchange different manufactured products, since barter is not sales under Ethiopian law, and if one of the individuals is injured due to the manufactured goods this article is not applicable. The sale should be to the public and for profit. An enterprise could, for instance, distribute food items free for the public. And if someone is injured due to that food, the victim may not be successful under this article. The fourth element is the phrase "…shall be liable for any damage…"Here

[158] Civil Code, Article 2085
[159]Nicholas J. Mebirde, Roderick Bagshawi, and Pearson Longman, *Tort Law*, 2nd ed., London, New York , 2006, P.764
[160] Ibid P.762
[161] John Cooke and Pearson Longman, *Law of Torts*, 8th ed., London, New York , 2007, P. 251 [Hereafter Cooke et al., Law of Torts]

[162]Civil Code, Articles 2077 and the following

any damage could mean damage to person[163] or damage to property. For instance, you may eat food and you could be ill. This damage is to person and the manufacturer[164] shall be liable.[165]It is similar if you buy a certain spare part and assemble it in your car and your car is damaged due to that spare part. And the last element is the phrase "…resulting from the normal use of the goods." Each good has normal use. The normal use of a chair is to sit on it. The normal use of edible oil is to cook food items not to drink like water. The chair or the all could be defective. Nonetheless, if someone suffers is while using the defective chair like a ladder the manufacturer shall not be liable. Neither the oil manufacturer is liable for the damage suffered by a victim who drank the oil. Nor is the manufacturer liable where the defect caused the damage could have been discovered by a customary examination of the goods.[166] Cooke illustrates this as follows:

Where it is reasonable to expect someone to inspect the goods before they are used, the manufacturer may not be regarded as the cause of the damage. If the goods were examined and the defect was negligently not identified, this makes the examiner a cause of the damage. It is not sufficient that someone had an opportunity to examine the goods; it must be shown that the manufacturer could reasonably expect that person to make an examination. For example, it would not be reasonable for a manufacturer to expect that a person would wash underwear before using it.[167]

Thus, from the very reading of the above articles of the Tort Law, we can safely say that the Tort Law is oriented in a way it could address environmental related type of damages which could affect vested interest of the plaintiff. So, tort law is not in a position to encompass damage to the environment per se which could affect the public interest, the intrinsic value of the environment, and the interest of the future generation. Moreover, it can be understood that what the Ethiopian tort law provides is only for the liability of the company (if it acts against what the law provides) itself without saying anything about the liability of the members of the Company. The tort law does not extend such liability to the shareholders or members of the company.

[163] A consumer is any one whom the manufacturer should foresee would be affected by the product. This will include purchasers, donee, and borrowers, employees of purchasers and bystanders who happen to be injured. See Cooke et al., Law of Torts, P. 251

[164] In conventional sense the word manufacturers applies to retailers, whole salers, repairers of products (Such as garages). See Cooke et al., Law of Torts, P. 253

[165] Commercial Code, Article 2085 (1)

[166] Ibid article 2088[2]

[167] Cooke et al., Law of Torts, P.253

CHAPTER THREE

3. THE DOCTRINES OF SHAREHOLDERS LIABILITY TO COMPANY'S TORT CREDITORS

As a legal person a company has certain powers 'necessarily and inseparably incident to every corporation' such as the power to conclude contracts.[168] Owing to the doctrine of limited liability, the transactions of a share company create legal rights and obligations vested in the company itself as opposed to its members. Limited liability allows for 'risk sharing' between the owners of the company and the outside parties with whom the company interacts and if the company fails, the effect of the doctrine is that losses are partly externalized – they fall upon external creditors.[169] Although this is generally seen as acceptable in the ordinary course of commerce, where incorporated businesses benefit from reciprocal risk transfers, it proves to be far less palatable where the costs of business failure fall upon tort claimants. This is because, at the outset of their relationship with the company, creditors can contract[170] for an adequate interest rate, possibly, for control rights on the company,[171] and ask for additional securities from the company.[172] Moreover, recently, under the current conditions of economic recession, creditors also ask for personal securities of shareholders for the obligations of the company. In such cases, creditors 'contract out of the doctrine of limited liability'.[173]

On the other hand, the company law protected the interest of shareholders of a company through the application of the doctrine of limited liability (save in exceptional cases) which, among

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[168] J.L. Stewart and M.L.Palmer, *Company Law of Canada*, 1962, (Toronto: The Carswell Company Ltd,5th ed.) P. 46, as cited by Seyoum Yohannes Tesfay, on Formation of Share Companies in Ethiopia, PP. 102-127, P. 104

[169] Contractual Creditors refers only to voluntary creditors (i.e. all of the creditors who contracted with the company at their own will). See also Olga Petroševičienė, Effective Protection of Creditors' Interests in Private Companies: Obligatory Minimum Capital Rules Versus Contractual and Other Ex Post Mechanisms*, Social Sciences Studies, 2010, Vol. 3, No. 7, PP. 213-228, P.221*

[170] Luca Enriques and Jonathan R. Macey, 'Creditors Versus Capital Formation: The Case against the European Legal Capital Rules, *Cornell Law Review*, 2001, Vol. 86, No. 1165, PP. 1168 and ff, P. 6, at: <http://scholarship.law.cornell.edu/clr/vol86/iss6/>. See also Barry E. Adler and Marcel Kahan, The Technology of Creditor Protection, *University of Pennsylvania Law Review*, 2013, Vol. 161, No. 7, PP. 1773-1814, P. 1778.

[171] For instance, a debtor is usually not entitled to invest, purchase or acquire assets of a particular value, to borrow or to lend particular sums, to mortgage or pledge real property, etc. without a prior written consent of the creditors. See Supra note 8 at 221.

[172]The securities may include real estate mortgage, pledge, bank guarantee, etc. See Ibid.

[173] Machado, F. S. *Mandatory Minimum Capital Rules or Ex Post Mechanisms*?, P.28 [interactive]. [accessed 10-07-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568731>.

others, shifts some of the costs of innovation and its failures to the creditors and employees of companies.[174] Limited liability is one of the major attractions of the corporate forms which permit those who invest in an incorporated business to limit potential losses.[175] Be that as it may, tort claimants are, however, unlikely to have opportunities to deal with the company that injures them.[176] Owing to this, different doctrines are being proposed in recent academic discourse to make all shareholders liable to company's tort creditors.

Thus, the aim of this chapter is to critically address the doctrines which focuses on the liability of shareholders to company's tort creditors.

3.1. The Doctrine of Limited Liability

The doctrine of limited liability is a fundamental principle of corporate law.[177] It is a standard feature of virtually every corporation with publicly traded shares.[178] It also appears indispensable to the proper operation of corporations in the market.[179] Under this doctrine firms acknowledge that debts will be paid only from the assets of the firm itself. The shareholders are not personally liable for more than they have invested in the firm.[180]

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[174] L.C.Backer, *Comparative Corporate Law*, Op cit, 995 as cited by Seyoum Yohannes Tesfay, Supra note 2 at 105

[175] Christian Witting, Liability for Corporate Wrongs, *The University of Queensland Law Journal, 2009,* Vol 28, No. 1, PP. 113-142, P. 113.

[176] Stephanie Ben-Ishai and Stephen Lubben, Involuntary Creditors and Corporate Bankruptcy, *UBC Law Review*, 2012, Vol. 45, No. 2, PP. 253-282, P. 257; It is argumentative whether the so-called 'involuntary creditors' excludes employees, consumers, trade creditors, and lenders. See Frank H. Easterbrook and Daniel R. Fischel, Limited Liability and The Corporation, *The University of Chicago Law Review*, 1985, Vol. 52, No. 1, PP. 89-117, P. 89

[177] Frank H. Easterbrook and Daniel R. Fischel, Limited Liability and The Corporation, *The University of Chicago Law Review*, 1985, Vol. 52, No. 1, PP. 89-117, at P. 89. [Here in after, Easterbrook et al., Limited Liability and The Corporation]

[178] Susan E. Woodward, Limited Liability in the Theory of the Firm, *Journal of Institutional and Theoretical Economics*, 1985, Vol. 141, No. 4, PP. 601-611, at P. 601. [Here in after, Woodward, Limited Liability in the Theory of the Firm]

[179] Peter Muchlinski, Limited Liability and Multinational Enterprises: A Case for Reform?, *Cambridge Journal of Economics*, 2010, Vol. 34, No. 5, PP. 903-937, at P. 915.

[180] Ibid. See also Easterbrook et al., Limited Liability and The Corporation, P. 90.

As a standard feature of the corporation today, unlike the equity holder in a partnership or proprietorship[181], the doctrine asserts that the assets that a shareholder has distinct from her/his holdings in the enterprise cannot be taken to satisfy liabilities arising from actions of the enterprise itself.[182] The liability of "the corporation" is limited by the fact that the corporation is not real, that it is no more than a name for a complex set of contracts among managers, workers, and contributors of capital and that it has no existence independent of these relations.[183] Because LLCs (Limited Liability Companies) limit the liability of members and managers, it follows that, unlike general partnerships, LLCs only protect creditors through rules regarding disclosure, distributions and dissolution.[184] Any extension of liability beyond the assets of the firm to the personal (extra-firm) assets of the shareholders must, in order to be enforceable, impair transferability of shares. [185] Shareholders hold a residual claim on the corporation's assets.[186]However, as Gordon G. Sollars explained, the shareholder's loss may be "large", even though it is "limited", and can certainly be more than the amount actually invested (due to share price appreciation).[187] If the corporation's liabilities, however, exceed its assets, the shareholders will receive nothing; they will have lost their entire investment.[188]

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[181] As one of its primary functions, the doctrine of limited liability differentiates LLCs(limited liability corporations) both from general partnerships, where all partners are generally liable for the debts of the partnership, and from limited partnerships, which must have at least one general partner who is personally liable for the obligations of the partnership. See Robert R. Keatinge, Larry E. Ribstein, Susan Pace Hamill, Michael L. Gravelle and Sharon Connaughton, The Limited Liability Company: A Study of the Emerging Entity, *The Business Lawyer*, 1992, Vol. 47, No. 2, PP. 378-395, at P. 385. [Here in after, Keatinge et al., The Limited Liability Company]

[182]Sollars, An Appraisal of Shareholder Proportional Liability, P. 329.

[183]Easterbrook et al, Limited Liability and The Corporation, P. 89.

[184]Keatinge et al, The Limited Liability Company, P. 385.

[185] "The connection between transferability and liability assignment is easily seen by imagining a firm with unconditionally salable shares which tries to extend liability to the shareholders (where the liable party is the holder of the share at the time request for resources are made). Were bankruptcy to threaten such a firm, any shareholders with assets worth the creditor's pursuit could simply sell their shares rather than pay up." See Woodward, Limited Liability in the Theory of the Firm, P. 602.

[186] Janet Cooper Alexander, Unlimited Shareholder Liability through a Procedural Lens, Harvard Law Review, 1992, Vol. 106, No. 2, PP. 387-445, at P. 390. [Here in after, Alexander, Unlimited Shareholder Liability through a Procedural Lens]

[187]Sollars, An Appraisal of Shareholder Proportional Liability for Corporate Torts, P. 342.

[188]Alexander, Unlimited Shareholder Liability through a Procedural Lens, P. 390. Janet Cooper Alexander argued that in such a situation, the shareholders would not, in whatever circumstances, incur a liability which is more than the amount of equity that they have invested in the corporation. On the other hand, Gordon G. Sollars stated in his footnote that modern portfolio theory counsels the rational shareholder to diversify her holdings, so that loses due to any one stock are not large relative to the investor's wealth. See also Sollars, An Appraisal of Shareholder Proportional Liability, P. 342

3.1.1. Justifications for the Doctrine of Limited Liability

People can conduct economic activity in many forms.[189] Those who perceive entrepreneurial opportunities must decide whether to organize a sole proprietorship, general or limited partnership, business trust, close or publicly held corporation.[190] Debt investors in all of these ventures possess limited liability so does equity investors in publicly held corporations, limited partnerships, and business trusts.[191] Limited liability for equity investors has long been explained as a benefit bestowed on investors by the state. It is much more accurately analyzed as a logical consequence of the differences among the forms for conducting economic activity.[192] As Judith Freedman stated, much of the literature evaluates limited liability on the basis of economic analysis or efficiency.[193] These measures of economic 'efficiency' operate within an overall framework of profit maximization.[194] The efficiency implications of limited liability depend on the considerations that it must be determined whether the limited liability of equity investors truly externalizes costs by removing consideration of costs from investors' decisions and that the measure of the risk of an activity to an investor may or may not reflect the social risk.[195]The general form of these arguments is to show how limited liability improves the functions of markets and lowers or avoids costs that would otherwise be incurred, typically with unlimited liability as the baseline.[196]

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[189]Easterbrook et al., Limited Liability and The Corporation, P. 93.
[190]Ibid.
[191]Ibid
[192]Ibid
[193]Judith Freedman, Limited Liability: Large Company Theory and Small Firms, *The Modern Law Review*, 2000, Vol. 63, No. 3, PP. 297-343, at P. 319. [Here in after, Freedman, Limited Liability: Large Company Theory and Small Firms] Freedman, however, argued that even accepting the measures and approach of economic analysis, there are strong arguments in support of the view that limited liability is not efficient for the smallest firms and that efficiency is not the only test to be applied. And that as quoted by Freedman, there may come a point at which we are prepared to choose above profit maximization: 'Efficient solutions are not always just solutions. The policy maker is concerned not only with the optimal allocation of resources but also with the appropriate distribution of resources as determined by moral and political criteria…'
[194] Ibid.
[195]As argued by Leebron, limited liability may be inefficient because it allows enterprises to externalize costs and makes activities less risky to investors than to society as a whole. The efficiency consequences of limiting liability thus differ with respect to contracted debt holders and potential tort victims. See David W. Leebron, Limited Liability, Tort Victims, and Creditors, Columbia Law Review, 1991, Vol. 91, No. 7, PP. 1565-1650, at P. 1574. [Here in after, Leebron, Limited Liability, Tort Victims, and Creditors]
[196]Sollars, An Appraisal of Shareholder Proportional Liability, P. 336.

The reasons in favor of limited liability are: Limited liability decreases the need for monitoring due to agency problems;[197] Limited liability reduces the costs of monitoring the wealth of other shareholders;[198]Limited liability gives managers incentives to act efficiently by promoting the free transfer of shares;[199] Limited liability reduces the costs of determining the "true" value of a share;[200] Limited liability allows more efficient diversification;[201] and Limited liability facilitates the corporation's optimal investment decisions.[202]

These assumptions about the fundamental economic significance of limited liability have, however, not been the subject of rigorous empirical testing and are open to attempts to refute them.[203] As will be explained below, their validity has been questioned. But clearly, limited liability has been seen as a key element in the growth of the industrial economy.[204] For this reason, courts have been reluctant to appear to undermine it.[205]

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[197] Jensen, M. and W. Meckling: 1976, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *The Journal of Financial Economics* 3, 305–360, as cited in Sollars, An Appraisal of Shareholder Proportional Liability, P. 336. Shareholders will have a greater incentive to monitor the activities of the board of directors and senior officers the more capital they have at risk, yet there must be some point at which the cost of monitoring outweighs the benefits. Limited liability sets a limit to these costs. See Ibid.

[198]With unlimited liability, the greater the wealth of a shareholder, the more the incentive to monitor the wealth of other shareholders, See Ibid.

[199] See Ibid.

[200]Since shares are fungible under limited liability, all shares have the same value, and most investors can accept the market price without engaging in costly information gathering. See Id, P. 337

[201] With limited liability the amount a shareholder puts at risk in one corporation is defined in advance, allowing for diversification of risk by holding shares in other corporations. See Ibid.

[202] Since limited liability supports diversification, investors will want the corporation to accept any project that has a positive net present value regardless of its (individual) risk. See Ibid.

[203]Henry Hansmann et al., Toward Unlimited Shareholder Liability for Corporate Torts, P. 573, 611

[204]See Richard Posner, *Economic Analysis of Law,* 4th ed, 1990, P. 393-98. [Here in after Posner, Economic Analysis of Law]; Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law', *University of Toronto Law Journal,* 1980, Vol. 30, No. 117, PP. 92-134, at P. 117-20 [Here in after, Halpern et al., An Economic Analysis of Limited Liability in Corporation Law]; Stephen Presser, 'Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics', Northwestern University Law Review, 1992, Vol. 87, N0.148, PP. 132-165, at P. 155-6. [Here in after, Presser, 'Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics]

[205]William Douglas and Carroll Shanks, 'Insulation from Liability through Subsidiary Corporations' Yale Law Journal, 1929, Vol. 39, No.193, PP. 163-217, at P. 193. The authors noting that limited liability is 'ingrained in our economic and legal systems'. Reluctance to impinge upon the doctrine has puzzled some corporate lawyers. Thus, it has been observed that '[a] major object of the law of torts is to shift the financial burden of the loss from the victim to the person whose activity caused the damage. There is no reason why a company … should not be held liable to pay compensation for harm flowing from civil wrongs in the course of its activities if a natural person in similar circumstances would have been liable'. See also RP Austin and IM Ramsay, *Ford's Principles of Corporations Law,* 12th ed, 2005, P. 807. [Here in after, Ramsay, Ford's Principles of Corporations Law]

3.1.2. Objections to Limited Liability

Because limited liability should be retained as the background rule for contract creditors, it would be necessary, if unlimited liability were adopted for tort claims, to distinguish clearly between claims against a corporation that arise in tort and claims that arise in contract.[206] Financial theory suggests that corporate creditors will adjust their terms in order to compensate for the ex ante risk they face due to limited liability.[207] This is because in theory, at least, contract creditors deal voluntarily with companies to which they extend credit.[208] They are able to examine the credit-worthiness of customers, take security on goods sold[209] and obtain guarantees.[210] Experience tells us that contract creditors with bargaining power often do insist upon the taking of guarantees – personal guarantees from directors and others.[211] However, the so-called "involuntary creditor"[212] has not had the opportunity to adjust credit terms, and so suffers an uncompensated loss when limited liability is invoked.

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[206]Henry Hansmann et al Toward Unlimited Shareholder Liability for Corporate Torts, P. 1921

[207]Posner, R. A., 'The Rights of Creditors of Affiliated Corporations', *University of Chicago Law Review,* 1976, Vol.43, **No**. 5, PP. 499–526, at P. 514.

[208]Brian Cheffins, *Company Law: Theory, Structure, and Operation,* 1997, P. 501. Theory does not always correspond to reality. See Helen Anderson, 'Creditors' Rights of Recovery: Economic Theory, Corporate Jurisprudence and the Role of Fairness', *Melbourne University Law Review,* 2006, Vol. 30, No.1, PP. 1-34, at P. 8-9; See also Michael Whincop, 'Overcoming Corporate Law: Instrumentalism, Pragmatism and the Separate Legal Entity Concept', *Company and Securities Law Journal,* 1997, Vol. 15, No.4, PP. 403-447, at P. 11, 430. Indeed, there are arguments that involuntary creditors include 'many trade creditors, consumers, and workers'. See Phillip I Blumberg, 'Limited Liability and Corporate Groups', *Journal of Corporate Law,* 1986, Vol. 11, No.3, PP. 547-662, at P. 573, 576 and 611. [Here in after, Blumberg, Limited Liability and Corporate Groups]

[209]For a summary of actions that a creditor might take involving secured finance. For some of the problems that arise, See Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?', *Modern Law Review*, 1999, Vol. 62, N0.7, PP. 612-645, at P. 633 (discussing, e.g., the problems faced by unsecured, non-adjusting creditors).

[210]These are not the only strategies that can be taken: Sale arrangements that serve as de facto means of taking security and imposition of contractual restrictions upon corporate activity. See Id, P. 634-5, and 642.

[211]Andrews Rogers, 'Reforming the Law Relating to Limited Liability', *Australian Journal of Corporate Law,*1993, Vol. 3, No. 1, PP. 112-149, at P. 136, 138; Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, P. 135. Where groups are concerned, 'it is common for creditors to require security on a group basis': Companies and Securities Advisory Committee, *Corporate Groups Final Report,* 2000, P. 17. This means the entering into of cross-guarantees between group members. Id, P. 47.

[212]'Involuntary Creditors' might refer to insiders such as employees or outsiders such as independent contractors, consumers and other third parties (including innocent bystanders injured when a product fails). Employees might be classed as 'involuntary creditors' where they do not have the opportunity to bargain with the company for which they work. See Christian Witting, Liability for Corporate Wrongs, P. 118

Tort claimants (involuntary creditors) are, therefore, recognized as a vulnerable group.[213] Their vulnerability is exacerbated by judgment-proofing within groups.[214]On account of this practice, LoPucki has opined that the tort liability system has begun to fail.[215] Deserving claimants are not being compensated as they should be. This is seen as both an inevitable and an accelerating process – accelerating because those enterprises that fail to judgment-proof themselves will be at a competitive disadvantage.[216] This ability to externalize costs reduces companies' incentives to take care in the conduct of their activities. More persons are injured than would otherwise be the case. It is thus clear that significant legal protection of tort claimants is required against the company – and, so it will be argued, its owners.[217]

3.2. Examining the Justifications of Limited Liability Doctrine

This section is devoted to examine how convincing the factors or reasons taken in support of the doctrine of limited liability are. Blumberg is of the opinion that there is no conceptual reason to equate the corporate form with limited liability. [218] The wider literature reveals that the assumptions about the need for limited liability have been questioned. Each of the assumptions will be examined below.

The first assumption relates to the separation of ownership and control. This argument is weak with respect to corporate parents, which have a financial incentive to monitor their subsidiaries.[219] Studies have indicated that parent companies often exercise a great degree of control over their subsidiaries' strategies and activities.[220] The argument is also a weak one with respect to companies at the other end of the spectrum – small closely-held firms in which the

[213]See Hon. A Rogers, 'Reforming the Law relating to Limited Liability', Speech to the Business Section of the Law Council of Australia, 1992.
[214]L. LoPucki, 'The Essential Structure of Judgment Proofing' 1998) 51 Stanford Law Review, 1998, Vol. 51, No. 2, PP. 1-68, at P. 20-3. [Here in after, LoPucki, 'The Essential Structure of Judgment Proofing']
[215]Id, P. 4.
[216]Ibid. This claim has been disputed. See also James White, 'Corporate Judgment Proofing: A Response to Lynn Lo Pucki's '*The Death of Liability*', *Yale Law Journal,* 1998, Vol. 107, N0. 12, PP. 1329-1398, at P.1363, 1394.
[217]Christian Witting, Liability for Corporate Wrongs, P. 119
[218]Blumberg, Limited Liability and Corporate Groups, P. 604.
[219]Ian Ramsay, 'Allocating Liability in Corporate Groups: An Australian Perspective', *Connecticut Journal of International Law,* 1999, Vol. 13, No. 4, PP. 322-367, at P. 329, 343.
[220]See, Jose Antunes, *The Liability of Corporate Groups*, 1994, P. 67-8. [Here in after, Antunes, The Liability of Corporate Groups*]*

shareholders are the day-to-day managers.[221] Where shareholders are removed from day-to-day corporate activities, a modified rule of limited liability would not necessarily compel them to more actively monitor companies in which they invest.

This is because a number of stakeholders already monitor management performance – including regulators, credit-rating agencies, institutions and creditors.[222]

The second assumption relates to shareholders monitoring each other. Shareholders might have an incentive to monitor each other under a rule of joint unlimited liability. However, this is not what is proposed in this paper.[223] This paper argues in favour of pro-rata unlimited liability in cases of death and personal injury. Liability under such a rule does not depend upon the level of each shareholder's wealth.

The third assumption relates to the shifting of costs of monitoring. This paper argues in favour of a modified rule of limited liability with regard to priority of payment on a winding up. Tort claimants will be better compensated for the personal injuries that they suffer if they are given priority over both secured creditors and (assuming that they are different persons) employees of the company.[224] This is justified by the fact that employees often can be seen as company 'insiders', while contract creditors have only financial interests at stake.[225]If the above argument

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[221]See, Freedman, Limited Liability: Large Company Theory and Small Firms, P. 331.

[222]Richard Booth, 'Limited Liability and the Efficient Allocation of Resources', *Northwestern University Law Review,* 1994, Vol. 89, No. 11, PP. 127-165, at P.140, 147; Presser, 'Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics, P. 159. It should be noted that only large and sophisticated creditors, such as banks, are likely to be willing and effective monitors of companies to which they extend credit. See Freedman, Limited Liability: Large Company Theory and Small Firms, P. 330.

[223] Even if monitoring became necessary, some commentators deride its importance in the context of tort claims: Booth, ibid 147. Note, also, that the efficacy of credit rating agencies has been questioned in recent times. See Securities Industry and Financial Markets Association, *Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Taskforce*, 2008, at <http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf> [last accessed February 25, 2017]; International Organization of Securities Commissions, *The Role of Credit Rating Agencies in Structured Finance Markets: Final Report*, 2008, at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> [last accessed February 25, 2017]. The Australian Government has announced plans for the regulation of credit rating agencies in order to restore confidence to securities markets. See D Crowe, 'PM toughens rules for ratings agencies', *The Australian Financial Review*, 2008, P. 1.

[224]Christian Witting, Liability for Corporate Wrongs, P.126

[225]Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, P. 139 and 141 (discussing the information likely to be available to employees about the company and its obligations).

is taken in the way suggested, one might expect contract creditors to monitor company behavior more prodigiously.[226] Costs would be reflected in the contracts that are entered into with the company.[227] To the extent that it makes a difference, this would assist in reducing the amount of injury-producing activity that occurs.

The fourth assumption relates to the need for investors to diversify their holdings of securities. This argument has been seen as the most crucial for risk-averse investors. The problem with unlimited liability is that it would seem to increase the risks of personal bankruptcy for those investing in more than one company.[228] However, the argument is less important with respect to parent companies than to natural person shareholders because the former are likely to be risk-neutral rather than risk-averse.[229]But more crucially, it is important to recognize that a modified rule of limited liability will only partly reduce the opportunities to diversify risks. Most shareholders will be able to limit their investments in companies engaged in injury-producing activities (at least where the risks are foreseeable) and focus on alternative investments.[230] In fact, shareholders will maintain the ability to invest across a broad range of asset classes, including debt instruments, real estate, commodities and cash.[231] Such diversification reduces the chance of losses from particular investments in risky companies and also reduces the chance of losses stemming from downturns in the economic cycle.[232]

The exception to these propositions concerns shareholders in smaller companies, who are more likely to invest all of their time and a large proportion of their wealth in their business ventures.[233] These shareholders may be unable to diversify their risks, until such time as their businesses begin to prosper and provide significant financial returns.[234] Even then, their ability to

[226]Ramsay, Ford's Principles of Corporations Law, P. 374

[227]Leebron, Limited Liability, Tort Victims, and Creditors, P. 1565, 1601-2.

[228]Leebron, Limited Liability, Tort Victims, and Creditors, P. 1597.

[229]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1879 and 1880

[230]Christian Witting, Liability for Corporate Wrongs, P. 126

[231]Leebron, Limited Liability, Tort Victims, and Creditors, P. 1596. See also Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1904.

[232] This is not to say that diversification across asset classes eliminates system-wide risks: See Larry E Ribstein, 'Limited Liability and Theories of the Corporation', *Maryland Law Review,* 1991, Vol. 50, No.80, PP. 78-104, at P. 89-1 and 103.

[233]Freedman, Limited Liability: Large Company Theory and Small Firms, P. 332

[234]Note that an argument has been made that limited liability should not, in any case, be granted to shareholders of small companies. See Ibid.

diversify will remain restricted by the call of their businesses upon their human capital.[235] Argument has been made in the literature for unlimited liability in the case of small, closely-held companies.[236]

The proposal in this paper does not extend that far. The exposure of shareholders in small companies (as with shareholders in all other companies) to company-specific risks will arise only in cases of personal injury – not in the more prevalent cases of financial loss. The arguments that exist in favour of limited liability are strongest with respect to contract debts and financial losses. In such cases, limited liability permits of risk-sharing and is relatively uncontroversial.[237]

3.3. Examining the Role of the Shareholder

The assumptions upon which the rule of limited liability has been enacted are even more tenuous than the arguments already made would indicate. Referring back to the argument about the way in which limited liability facilitates the separation of ownership and control, it should be recognized that shareholders cannot simply be assumed to either want to be, or to be, passive investors in the company. Recent scholarship has observed the increasingly activist nature of shareholders and the growing number of conflicts to which they are exposed. This has led to a number of proposals to reform the law governing shareholders.[238] In a major contribution to the debate, Anabtawi and Stout have declared that the American corporate landscape has changed substantially since Berle and Means' time.[239] Changes in markets, business practice and business institutions, and in corporate and securities law, have seriously eroded the realism of the standard assumptions that shareholders are passive and powerless'.[240]

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[235] This point applies even under a limited liability regime. See Ibid.

[236] Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, P. 148.

[237] This is not to say that there is no controversy at all: See, John Farrar, *Corporate Governance: Theories, Principles, and Practice,* 2nd ed, Melbourne, 2006, P. 26.

[238] Christian Witting, Liability for Corporate Wrongs, P. P.127

[239] The reference here is to Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property,* 1932, P. 7, 66, 78 and 82 (a seminal work which observed the growing trend in US corporations to be too large for detailed oversight by individual investors, power thus moving to boards of directors).

[240] Iman Anabtawi and Lynn Stout, 'Fiduciary Duties for Activist Shareholders', *Stanford Law Review,* 2008, Vol. 60, No.7, PP. 1243-1267, at P. 1255, 1275[Here in after, Anabtawi, Fiduciary Duties for Activist Shareholders]. What has been said about the US corporate scene applies mutatis mutandis to the Australian scene.

The authors argue that shareholders have become more powerful. This is seen in the rise of institutional investors, such as mutual funds and superannuation funds.[241] Although these investors' holdings in particular companies may be only a small proportion of their total investments, the institutions' collective force is potentially great because they can co-ordinate action through shareholder advisory services, such as Risk Metrics.[242]In more recent times, these institutions have been joined by activist hedge funds. The hedge funds are less likely to have diversified holdings, more likely to target particular companies and also more likely to demand accommodations to their demands.[243]

Shareholders have been provided with greater incentives to become active through financial innovation. Financial innovation permits of opportunities for 'investors who purchase one type of security to push for corporate actions that harm the value of another type of security issued by the same company'.[244] It also has 'lowered the cost of activist strategies by allowing the separation of voting rights and economic interests. Thus, a hedge fund can buy a block of [shares] and vote the shares while simultaneously entering a derivatives contract that hedges away its economic interests in' them.[245]The authors point out that shareholder conflicts may arise not only through obvious means such as the award of contracts and advisory agreements, but also through the taking of "'adverse positions" in derivatives or in securities issued by other companies'.[246] The authors note that '[t]he underlying disease is shareholder opportunism'.[247] They seek new responses to the changed position of the shareholder.[248] They would have the courts recognize a duty of loyalty owed by the shareholder in any situation where they seek 'to

[241]Id, P. 1275-6.
[242]Id, P. 1277.
[243]Id, P. 1279.
[244]Id, P. 1280.
[245]Ibid. It has been observed: 'The theoretical possibility of decoupling votes from economic ownership is not new. What is new is investor ability to do so on a large scale, declining transaction costs due to financial innovation, and a trillion-dollar-plus pool of sophisticated, lightly regulated, hedge funds, free from conflicts of interest and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies'. See Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morph able) Ownership', *Southern California Law Review,* 2006, Vol. 79, N0. 4, PP. 807-843, at P.811, 819. The latter authors survey the means of decoupling. See Id, P. 823-49. See also the more recent piece Henry Hu and Bernard Black, 'Equity and Debt Decoupling II: Importance and Extensions', University of Pennsylvania Law Review, 2008, Vol. 156, No. 16, PP. 612-168, at p.625.
[246]Anabtawi, Fiduciary Duties for Activist Shareholders, P. 1286.
[247]Id, P. 1294.
[248]Christian Witting, Liability for Corporate Wrongs, P. 128

promote a corporate strategy or transaction in which that particular shareholder has a material, personal pecuniary interest'.[249]

While the particular problems that Anabtawi and Stout speak of are not of direct concern to this paper, the basic facts which give rise to them are nevertheless of considerable interest. In Australia, it is clear that an increasing proportion of shares in major companies are now beneficially owned by, not individuals but, institutional investors.[250] These shares are not, however, registered in the names of the institutions – often they are registered in the names of custodians. Moreover, the institutions may not actually vote their shares – but may leave policy-making and voting in the hands of advisers such as Risk Metrics.[251] This means that it is increasingly incoherent to insist upon control as a criterion for shareholder liability.[252]

3.4. Appropriate Tort Rules for Shareholders

It is sometimes argued that, even if unlimited liability could be imposed on corporate shareholders without seriously interfering with the capital markets, the broad potential scope of enterprise liability under prevailing liability rules and damage measures constitutes an independent reason for favoring limited liability.[253] For example, one might be concerned that unlimited liability would thrust upon shareholders the risk of very large losses associated with very low probability accidents-the type of losses that insurance will not cover and that shareholders will find hard to assess, or to avoid by monitoring management.[254] More graphically, the concept of unlimited liability seems to engender in the minds of many the image of small passive shareholders with modest means being suddenly and unexpectedly thrown into personal bankruptcy when the few shares of publicly-traded stock they own bring upon them massive personal liability for some corporate tort.[255]

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[249] Id, P. 1295-6.
[250] See Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia,* Commonwealth of Australia, 2007, P. 6.
[251] Id, P. 3-4.
[252] Christian Witting, Liability for Corporate Wrongs, P. 129
[253] Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1916
[254] Id, P. 1916 and 1917
[255] Id, P. 1917

With unlimited liability, it will remain to the courts to determine which costs are efficiently and equitably borne by a corporation and its shareholders and which are not.[256] Some costs associated with corporate activity should be left on victims or their insurers rather than borne by corporation or, particularly, their shareholders.[257]But there is no reason to believe that this will always be the case, as the prevailing limited liability regime necessarily presumes.[258] Shareholders who benefit, for example, from intentional dumping of toxic wastes or from marketing hazardous products without warnings by the firm to pose substantial health risks, should not be able to avoid the resulting costs simply by limiting the capitalization of their firm.[259] In this respect, the courts should appropriately consider the structure of particular corporate defendants in determining the extent of their tort liability under an unlimited liability regime. For example, when the defendant corporation is the wholly-owned subsidiary of a large parent corporation, the prospect that a judgment might exceed the corporation's net assets and thus spill over onto its parent shareholder should generally not, in itself, affect the size of the judgment.[260] When the firm's shareholders are individuals, however, the prospect of shareholder liability might sometimes be a reason to temper the amount of the damages assessed.[261] Moreover, among firms with individual shareholders, it may often be worthwhile to distinguish between small closely-held firms and publicly-held firms.[262] For example, corporate liability that is justified on the grounds of risk-bearing (insurance) is more sensibly imposed on individual shareholders in publicly-held firms than on shareholders in privately-held firms, since public shareholders presumably have better-diversified investments.[263] Similarly, smaller judgments against closely-held firms will often be justified for purposes of deterrence, since liability is likely to deter risk-averse shareholders with concentrated stock-holdings more readily than diversified shareholders in public corporations.[264]

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[256] Ibid.
[257]For example, as Schwartz has cogently argued, risks that are "remote" (in his parlance) should often be left to lie where they fall. See Schwartz, Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship, *Journal of Legal Studies*, 1985, Vol. 14, No. 5, PP. 662-726, at P. 689, 716-17 (advocating abolition of limited liability for "knowable tort risks," though without specifying whether shareholders or only directors should be personally liable in an alternative regime)
[258]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1917
[259]Ibid.
[260]Ibid.
[261]Ibid.
[262]Ibid.
[263]Ibid.
[264]Ibid.

To be sure, whether courts are capable of distinguishing among corporate defendants is irrelevant if one believes that courts are inclined to create excessively broad liability for corporate actors in general-for example, in the realm of products liability"'[265]-and that limited liability therefore serves to restrain judicial overreaching. In this case, one might fear that unlimited liability would simply lead courts to search for deeper pockets for compensating victims, and thus encourage judges to be even more irresponsible than in the past in making unjustifiably large damage awards.[266] Yet this argument is not compelling. There may be good reasons for retreating somewhat from recent expansions of enterprise liability, although this remains a debatable issue.[267]But, even so, limited liability is an extremely crude check on the courts; it restricts liability excessively in some cases and not enough in others, and it motivates shareholders and corporations to behave opportunistically.[268] If the scope of enterprise liability needs to be narrowed, the appropriate reform is not to invite firms to opt out of the tort system by exploiting limited liability. Rather, one should craft liability rules and damage measures that impose costs upon corporations and their shareholders only to the extent that these actors appear to be the cheapest cost avoiders and/or insurers.[269] Indeed, there is already evidence that the courts have recently, on their own, begun taking a more conservative approach to enterprise liability.[270] Moreover, precisely the opposite argument seems equally plausible: with unlimited liability, courts would be forced to consider the appropriate scope of enterprise liability more thoughtfully, in the full awareness that limited liability would not automatically constrain any tendency toward excessive liability.[271] Courts could not award generous damages under the illusion that only corporations, and not individuals, would bear the resulting costs.[272] Rather, they could not escape the fact that tort liability large enough to bankrupt a publicly held corporation would also impose direct costs upon thousands of individual shareholders.[273] The focus here is that tort law usefully discourages the most severe forms of opportunistic cost

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[265]See Viscusi, The Dimensions of the Product Liability Crisis, *Journal of Legal Studies*, 1991, Vol. 20, No. 147, PP. 168-186, at P. 176-77 (doctrinal change has led to product liability crisis).
[266]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1918.
[267]See Croley and Hanson, What Liability Crisis: An Alternative Explanation for Recent Events in Products Liability, Yale Law Journal, 1990, Vol. 8, No. 1, PP. 1-37, at P. 1.
[268]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts , P. 1918.
[269] Ibid.
[270]See Henderson and Eisenberg, The Quiet Revolution in Products Liability: An Empirical Study of Legal Change, *Ucla. L. Review*, 1990, Vol. 37, No. 12, PP. 467-492, at P. 479.
[271]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1918.
[272] Ibid.
[273] Id, P. 1918 and 1919

externalization.[274] Moreover, if any class of actors is likely to respond rationally to the deterrence incentives created by tort law, it is corporations and their shareholders.[275] Similarly, if tort law is to have any role in shifting risks to low-cost insurers, then using it to shift risks to the equity market makes sense.[276] Consequently, allowing corporations to avoid tort liability through the simple device of limited liability seems, at the very least, highly suspect.[277]

3.5. Conflict of Laws

State corporation statutes are commonly silent, or at least ambiguous, as to whether shareholders have limited liability for corporate torts.[278] This is appropriate since, as argued, shareholder liability for corporate torts should be viewed as a question of tort law rather than corporate law.[279] In general, the rules of tort law applied to a given accident should be those of the jurisdiction in which the tort occurred rather than the jurisdiction in which the defendant firm was incorporated.[280]The contrary choice of law rule would give rise to an adverse selection problem (a "race to the bottom") in which states would have an incentive to adopt inefficient corporation statutes that limit the tort liability of shareholders as much as possible and hence benefit shareholders (and the state, through the corporation franchise fees it could charge) at the expense of out-of-state tort victims.[281]

3.6. Experience with Unlimited Liability and its Historical Developments

It is common today to think of limited liability as an integral part of the corporate form and therefore to feel that abolishing limited liability, even in tort, would be recklessly

[274] Id, P. 1919
[275] Ibid.
[276] Ibid.
[277] Ibid.
[278]Providing only that shareholder shall not be personally liable for a corporation's "debts". The Revised Model Act has an unfortunate provision stating that a shareholder is "not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct". See Model Business Corporation Act, 1984, (revised) (emphasis added), which might be read as an effort to immunize shareholders from personal liability for a corporation's torts as well as for its contractual debts
[279]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts , P. 1921
[280] Ibid.
[281]Although it is arguable that, in general, competition among states for corporation charters creates pressure toward efficiency in state corporation statutes. See Winter, State Law, Shareholder Protection, and the Theory of the Corporation, *Journal of Legal Studies*, 1977, Vol. 6, No. 1, PP. 241-264, at P. 251. This is not the case where the costs of inefficient law are borne by third parties, such as out-of-state tort victims. Thus, if state corporation law could freely govern the extent of liability for corporate torts, Delaware would have a strong incentive to amend its corporation statute to establish, say, a cap of $5,000 on any corporation's liability for any tort.

revolutionary.[282]But limited liability in both tort and contract evolved over the past 150 years and did not become universal even in the United States until about fifty years ago.[283]

Blumberg has recently offered an extensive and thoughtful survey of the historical experience with unlimited liability.'[284] As he points out, in England prior to 1844, manufacturing firms had difficulty obtaining corporate charters. [285] Consequently, large manufacturing firms were commonly formed as unincorporated joint stock companies with transferable shares.[286] Indeed, an active public market in the shares of such companies developed as early as the seventeenth century.[287] These firms had roughly the legal characteristics of a large partnership, including unlimited joint and several liabilities for all corporate obligations.[288] Then, between 1844 and 1855, joint stock companies were permitted to incorporate but had to retain unlimited liability.[289] Only after 1855 was incorporation with limited liability generally available.[290] Prior to 1855, joint stock companies commonly sought to limit their shareholders' liability to voluntary creditors by contractual means, thus providing evidence that limited liability is the appropriate default rule for contractual obligations.[291] Such devices presumably did not succeed, however, in limiting liability in tort.[292] Nevertheless, by 1844 there were almost 1,000 joint stock companies in England, some with thousands of shareholders.[293] Similarly, although American states freely granted corporate charters by the beginning of the nineteenth century, for the first several decades of that century a number of states imposed unlimited liability on manufacturing corporations.[294] Nevertheless, many manufacturing firms incorporated in this period. Moreover, states that were slow in adopting limited liability, such as Massachusetts (1830) and Rhode Island (1849), did not appear to suffer a conspicuous disadvantage in industrial development in

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[282]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1923.
[283]Ibid.
[284]P. Blumberg, The Law of Corporate Groups: Substantive Law, 1987, P. 681-92. [Here in after, Blumberg, The Law of Corporate Groups: Substantive Law]. Blumberg Suggested abolition of limited liability among firms within "corporate groups. See, Id, . 573.
[285]Ibid.
[286]Ibid.
[287]Henry Hansmann et al, Toward Unlimited Shareholder Liability for Corporate Torts, P. 1924
[288]Ibid.
[289]Blumberg, The Law of Corporate Groups: Substantive Law, P. 9-15
[290]Ibid.
[291]Ibid.
[292]Id, P. 15-20
[293]Id, P. 9-23.
[294]Ibid.

comparison to neighboring states, such as Connecticut and New Hampshire that adopted limited liability earlier.[295] And, although most American states had adopted limited liability for corporations in general by the 1850's, California imposed unlimited pro rata liability by statute on the shareholders of both domestic and foreign corporations from statehood in 1849 until 1931, evidently without crippling industrial and commercial development.[296] Even after discarding unlimited liability, many states provided for double or triple shareholder liability for corporate debts throughout the nineteenth century-liability that, at least originally, extended to tort creditors as well. Similarly, most states, as well as federal banking legislation, imposed double liability on the shareholders of banks until the 1930's.[297] An efficient mechanism, in the form of a procedure in equity termed the "creditors' bill," ultimately evolved to provide a means for obtaining a collective judgment, good against all shareholders, that was res judicata in other jurisdictions and subject only to personal defenses such as the number of shares actually held."[298] This extensive experience suggests that a regime of unlimited liability is administrable and that corporations with publicly traded shares can survive and prosper under it.[299] Prospective shareholders will not all be scared away.[300] Moreover, in the past, unlimited liability regimes for joint stock companies often employed joint and several rather than pro rata liability. If such a regime is viable, presumably a regime involving unlimited liability only in tort, and with pro rata liability, is much more so.[301]

3.7. The Alternatives to Unlimited Liability

Despite the attractions of unlimited liability as a means of regulating safety and investment incentives, the possibility remains that alternative legal reform could achieve the same effects at lower cost.[302] Indeed, most commentators who question the incentive effects of limited liability recommend reforms short of imposing unlimited liability on all shareholders.[303] The most commonly mentioned reforms fall into three categories: "coverage-oriented" reforms, which seek

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[295]Id, P. 23-38.
[296]Ibid.
[297]Id, P. 42-49.
[298]Id, P. 52-53.
[299]Henry Hansmann et al, Toward unlimited Shareholder Liability for Corporate Torts, P. 1925.
[300]Ibid.
[301]Ibid.
[302]Id, P. 1926
[303]Ibid.

to guarantee that firms have adequate resources to satisfy tort judgments; "liability-shifting" reforms, which shift responsibility for the firm's excess tort liability to contractual participants in the firm other than its shareholders; and "veil-piercing" reforms, which broaden the categories of cases in which courts disregard the corporate boundaries.[304]

Although all three genres of reform could mitigate the perverse effects of limited liability, there are strong reasons to believe that none would prove as effective as an unlimited liability regime.[305] For instance, in case of 'veil piercing', studies have indicated that courts are more hesitant to pierce the veil in tort cases than in contract cases.[306]And that they are more hesitant to impose liability upon corporate parents than upon natural person shareholders.[307] This means that veil-piercing is unlikely to be relevant to the case of a large company responsible for mass torts.[308] Moreover, as Sollars explained, the shareholder's loss may be "large", even though it is "limited", and can certainly be more than the amount actually invested (due to share price appreciation).[309]Thus, one might agree with LoPucki that the law has yet to respond adequately to the challenges of judgment-proofing.[310] The goals of tort law are being subverted by the operation of corporate law doctrines.[311] This cannot be tolerated since the problem is expected to increase over time with global movements of natural resources, goods and components, mass

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[304]Ibid.
[305]Ibid.
[306]Ian Ramsay and David Noakes, 'Piercing the Corporate Veil in Australia', *Company and Securities Law Journal* , 2001, Vol. 19, No. 3, PP. 245-276, at P. 250, 259 and 264. The explanation of this may be that claims are litigated in contract cases only when there is some certainty that a remedy will be in the offing.
[307]Henry Hansmann et al Toward Unlimited Shareholder Liability, 94. See also Ramsay and Noakes, Id, P. 263.
[308]Stephen M Bainbridge, 'Abolishing Veil Piercing', *Journal of Corporate Law*, 2001, Vol. 26, No 7, PP. 469-547, at P.523 (noting that piercing is more likely to occur in the case of a single-car taxi company owner than in the case of Union Carbide).
[309]Sollars*,* An Appraisal of Shareholder Proportional Liability, P.342.
[310]Hugh Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration', Modern *Law Review,* 1990, Vol. 53, No. 4, PP. 712-753, at P.731, 737, 732. This failure of company law to respond is reflected, e.g., in the pre-James Hardie publication Companies and Securities Advisory Committee. See Companies and Securities Advisory Committee, *Corporate Groups Final Report,* 2000, P. 17. The Advisory Committee decided not to recommend any changes to the law with respect to either tort liability within corporate groups or the priority of intra-group claims in the insolvency of a group company. However, it was recommended that courts be permitted to make pooling orders to 'enable courts to more closely monitor how particular corporate groups have conducted their affairs'. Id, P. 145.
[311] Paul Spender, 'Weapons of Mass Dispassion: James Hardie and Corporate Law', *Griffith Law Review,* 2005, Vol. 14, No. 9, PP. 271-303, at P. 280, 285-6. See also Robert Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise', *Vanderbilt Law Review,* 1994, Vol. 47, No. 1, P. 1. [Here in after, Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise]

production and distribution, and ever-increasing reliance upon artificial materials, chemicals and other substances.[312]

3.8. Limited Liability and Natural Person Shareholders

Parent company responsibility (for they exercise control over their subsidiaries such as allocating resources) for the personal injuries caused by the torts of their subsidiaries would create an important source of compensation.[313] In most cases, this would be enough to satisfy the claims of tort claimants.[314] However, the odd case will arise in which this will not be true. And so the question arises whether the law should go further in modifying the rule of shareholder limited liability. There are good arguments for dealing with all shareholders in the same way – in order to avoid differential pricing and distortion. A number of proposals call for a re-consideration of the doctrine with respect to natural person shareholders.[315] These shall be considered below.

3.8.1. Henry Hansmann and Reinier Kraakman[316]

In a well-known paper, Hansmann and Kraakman express a desire to give effect to the primacy of tort law doctrines over those of company law. They argue in favour of pro-rata unlimited liability for the torts of the company to be attached at the time of knowledge that claims will be made. The reason for extended shareholder liability for the torts of the company is to ensure that 'share prices reflect tort costs'.[317] Lower share prices mean greater pressures on managers. Such pressures will induce managers to properly consider risks and communicate fully about projects in which they believe the company should invest.[318] Overall, the result should be the undertaking of a lower level of risky activity than presently occurs.

Hansmann and Kraakman argue in favour of pro-rata rather than joint liability because the latter could potentially result in a single shareholder assuming the liabilities of an entire corporation –

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[312]Christian Witting, Liability for Corporate Wrongs, P. 125
[313]See Antunes, The Liability of Corporate Groups, P. 67-8.
[314]Ibid.
[315] According to one commentator, in 'traditional piercing cases the judicial focus has not been on passive shareholders but rather on active investors. See Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, P. 29.
[316]Henry Hansmann et al Toward Unlimited Shareholder Liability for Corporate Torts, P. 1879 and 1880
[317]Id, P. 1903.
[318]Id, P. 1907.

depending on the financial status of the other shareholders. Theory suggests that it would then become imperative for shareholders to monitor each other – and for decisions to invest to be made on the basis of shareholder wealth. The potential also arises for shares to be valued differently according to the wealth of each owner.

Hansmann and Kraakman argue also for liability to attach on the basis of knowledge of pending claims in order to avoid a number of problems with the alternatives, including obvious attempts to evade responsibility. 'This information based rule would fix liability before shareholders could evade responsibility for tort damages, without creating the uncertainties and complexities that would attend an occurrence rule'.[319] They would retain limited liability for contractual debts. They also acknowledge that their proposal would operate in ways which might seem harsh – in particular when passive shareholders are held liable for vast losses.

Hansmann and Kraakman argue that this harshness could be alleviated by the exercise of court discretion in the award of damages.[320] However, there is an argument against such an approach on the basis that it is not for judges to play fast and loose with the full compensation principle; any attempt to do so would undermine the idea that tort law is to prevail over company law doctrines. It is submitted that the better approach is to limit the exposure of shareholders by restricting claims to those for death and personal injury.

Hansmann and Kraakman's proposal has been the subject of intense scrutiny in the literature and substantial criticism. A first criticism is that the rule that they propose would be easy to evade – by way of off-shore purchases of shares, rendering judgments against shareholders unenforceable.[321] But this strategy would entail other, off-setting risks – most notably the problem of adverse movements in exchange rates and the risk of foreign transaction losses. It would also create certain problems which have been discussed, including difficulties for shareholders trying to monitor management and in enforcing any claims that the shareholder might have against the company. A second criticism is that a pro-rata rule would bring with it

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[319] Id, P. 1897.
[320] Id, P. 1917.
[321] Joseph Grundfest, 'The Limited Future of Unlimited Liability: A Capital Markets Perspective, *The Yale Law Journal,* 1992, Vol. 102, No. 2, PP. 387-425, at P. 387, 393, 395 and 399.

extremely high enforcement costs.[322] Indeed, this is a problem for the United States litigation system, where all parties carry their own costs regardless of the outcome of actions.[323] Such a rule does not apply in Australia, which adopts instead a rule that 'costs follow the event'.[324]A third criticism is that a rule of unlimited liability might lead to the disaggregation of enterprises and co-ordination of activities by way of 'independent contracts'. This is different (so it seems) from mere judgment-proofing because it means not only isolating risky corporate activities, but splitting up groups and larger companies within groups. Larger companies would be divided up and run as smaller companies linked by contracts. This is on the rationale that smaller companies are more likely to present challenges of enforcement and to be judgment-proof.[325]

However, it is submitted that this kind of disaggregation would be unlikely to follow any move to a rule of unlimited (or modified limited) liability. A number of problems would present themselves. First, it would be difficult for any presently existing company to find willing buyers for its more risky business activities. Any purchaser of such assets will seek 'independent gain'.[326] Second, it is well understood that enterprises gain all sorts of efficiencies (for example with respect to raising debt finance) when they operate either as a single company or as a closely integrated group.[327] 'An incentive for disaggregation in any given case would not arise under unlimited liability unless the resulting inefficiencies, including lost economies of scale or quality of management, were smaller than the private gains from avoiding potential tort liability'.[328] Third, coordination costs would arise, as would risks of opportunism. There will always be some residual loss from strategic behavior that slips through the net of coordination efforts. Disaggregation is a high-risk strategy to adopt ex ante.

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[322]Id, P. 397-7.

[323]This is acknowledged in Henry Hansmann and Reinier Kraakman, 'Do the Capital Markets Compel Limited Liability? A response to Professor Grundfest', *The Yale Law Journal* , 1992, Vol. 102, No. 2 , PP. 427-436, at P. 427, 432.

[324] See Corporations and Markets Advisory Committee, *Shareholder Claims Against Insolvent Companies: Implications of the Sons of Gwalia Decision* Discussion Paper, 2007, P. 30.

[325]LoPucki, 'The Essential Structure of Judgment Proofing', P. 64-6.

[326] Steven Schwarcz, 'The Inherent Irrationality of Judgment Proofing', *Stanford Law Review* , 1999, Vol. 52, No. 1, P. 3.

[327]Alfred Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism,* 1990, P. 14-8 (noting the general advantages of scale in the manufacturing industry); Hansmann and Kraakman, above n 12, 1914 (noting that 'an individually-owned firm with substantial firm-specific assets will have difficulty obtaining debt financing').

[328]Henry Hansmann et al., Toward Unlimited Shareholder Liability, P. 1914.

3.8.2. Nina Mendelson[329]

Mendelson believes that all shareholders with the capacity to exercise control should be liable in an unlimited amount. This is on the basis that those who control the company have better access to information than do ordinary shareholders, the ability to influence management decisions and 'special opportunities to benefit from corporate activity' (including the ability to find synergies between businesses with which they are associated, to control the payment of dividends and to write off the losses of one subsidiary against another).[330]And Mendelson recognizes an important point about companies that injure – that key shareholders have a greater capacity to avoid the causation of harm than do tort claimants. 'Compared with an individual tort victim, controlling and institutional shareholders both can better monitor the extent of the firm's research into product risks and act on that information to influence the corporation to address the risks…'.[331]

Unlike Hansmann and Kraakman, Mendelson would base liability on the capacity to control rather than on the mere ownership of shares.[332] She would also allow for joint liability amongst the controllers of the company with a right to contribution – thus doing away with costly enforcement. But the problem is that this re-introduces the need for costly monitoring by shareholders of management and of each other. Mendelson also acknowledges that her proposal has a significant hole in it – it offers no compensation for tort victims in cases where there are no controlling shareholders.[333] For this reason alone her proposal cannot be seen as an answer to the problems of limited liability and judgment-proofing.

3.8.3. Christopher Kutz[334]

Kutz presents the most radical of the proposals for reform of the rule of limited liability. He would impose liability upon all shareholders on the basis of his rejection of some of the ordinary assumptions about responsibility. He rejects the 'individual difference' principle. This is the idea that responsibility should flow only in those circumstances where the individual has made a

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[329]Nina A. Mendelson, A Control-Based Approach to Shareholder Liability, P. 1203-303.
[330]Id, P. 1206. It has also been said that 'controlling shareholders [are] among the principal beneficiaries of opportunism vis-à-vis creditors'. See Henry Hansmann and Reiner Kraakman, 'The Essential Role of Organizational Law', *Yale Law Journal ,* 2000, Vol. 110, No.1, P.387, 395-6.
[331]Nina A. Mendelson, A Control-Based Approach to Shareholder Liability, P. 1222.
[332]Ibid.
[333]Id, P. 1280-1.
[334]Kutz, Complicity – Ethics and Law for a Collective Age, P. 2

difference in a causal sense to the outcome of an event.[335] He also rejects the 'control principle'. This is the idea that the agent is only accountable for the acts and outcomes over which he or she has control.[336]

Kutz notes that the ordinary assumptions about responsibility 'define an individualistic conception of moral agency'.[337] He prefers a collective conception of moral agency. A key element is that collective responsibility flows from the participatory intention of the agent.[338] This is on the basis that 'intentional participation generally shapes agents' normative relations to the consequences of collective action, as well as their relations to other members of the group'.[339] He says that participation on these terms means that agents can be accountable for the outcomes attributable to the group as a whole as well as for those attributable to other members where 'done for the sake of the institution's goals, in conformity with restrictions on those members' participatory powers'.[340] This is to point to the fact that there is an intention on the part of agents by which they 'conceive of their [own] actions as standing on a certain instrumental relation to the group act'.[341]

Turning more specifically to the company, Kutz is of the opinion that the corporation is a 'co-operative structure'. In such a structure, each individual cooperates by contributing either financial or human capital.[342] 'The corporation and its goals exist only in virtue of this participatory structure. Restricting liability to corporate assets only makes sense on the assumption that there is something, the corporation, and no one else' that stands behind it.[343] He opines that the participatory intentions of shareholders mean that they can be held accountable for the wrongs of the company even if they are not blameworthy.[344]

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[335]Id, P. 3.
[336]Id, P. 3.
[337]Id, P. 4.
[338]Id, P. 67.
[339]Id, P. 69.
[340]Id, P.69 and 107.

[341]Id, P. 78.
[342]Id, P. 253.
[343]Ibid. It has long been recognized that the reality is that 'a corporation is at bottom but an association of individuals united for a common purpose and permitted by law to use a common name'. See AA Berle Jr, 'The Theory of Enterprise Entity', *Columbia Law Review*, 1947, Vol. 47, N0. 3, P. 352.
[344]Kutz, Complicity – Ethics and Law for a Collective Age, P. 246.

There are some important elements in this reasoning, which deserve comment. First, Kutz does not depart completely from the free-will paradigm of responsibility that he ostensibly rejects. He takes comfort (so it would seem) in finding that relevant 'intentions' exist at the time that a member of a company takes up his or her shareholding – rather than at the time of the injurious interaction. The question is whether this is necessary to a holding of liability. This is because there are arguments for a conception of shareholder liability that does not depend upon any ex ante intention or ex post proof of fault in the person to be made liable. Liability should depend upon a comparison of the position of the physical loss that tort claimants have suffered as against the potential financial losses that shareholders would suffer if made liable. Second, Kutz identifies the fact that shareholders are insiders. They play a particular function within companies that injure.[345] A function indicates the role played by the particular part in the operation of a whole system.[346] A part which plays a vital function in the operation of the system can be said to be necessary or intrinsic to that whole. A part which is not necessary in this way might nevertheless contribute to the overall efficacy of the system.[347] The idea of a function is important in certain legal contexts in determining the relationships between legal persons.

Kutz is right to believe that the idea is important in relating the company to the shareholder.[348] The very point and purpose of shareholders is that they arm companies with the funds that companies require to undertake activities that lead to injury.[349] This is a function that is legally significant and provides a potential basis for liability – a matter which is fully recognized by the legislature in its decision to grant shareholders the privilege of limited liability. The legislature has at once recognized the potential for liability to fall upon the shareholders and at the same time determined that they should be protected from this result. It is the extent of that legislative protection which, it is submitted, now requires re-assessment. Third, when shareholders make

[345]This point has been noted by writers of a very different stripe from Kutz. See Easterbrook et al., Limited Liability and the Corporation, P. 94.
[346]Andrei Marmor, *Positive Law and Objective Values,* 2001, P. 158.
[347]Jules Coleman, *The Practice of Principle: In Defence of a Pragmatist Approach to Legal Theory,* 2001, P. 25-31 (discussing functionalism in its causal and 'hermeneutic' senses).
[348]See Peter Cane, *Responsibility in Law and Morality,* 2002, P. 42. [Here in after, Cane, Responsibility in Law and Morality]
[349] Note, in another context, that the financing of terrorist activities is an unlawful function under various instruments. See T Stacy, 'The "Material Support" Offense: The Use of Strict Liability in the War Against Terror', *Kansas Journal of Law and Public Policy,* 2005, Vol. 14, No. 3, P.461.

their choice to extend funds; they identify themselves with the companies in which they invest. This identification manifests itself in the shareholder who attends 'her company' meeting or who reads the newspaper to see how 'his company's' share price is doing. These practices reflect the facts that the company is accountable to shareholders and that shareholders have a right to share in the spoils of the company in proportion to its profitability. There is a strong argument, then, that outsiders should be able to identify shareholders with those companies in which they invest. This argument is in no way diminished by the commonness of share ownership – by the fact that 'mums and dads' comprise a great proportion of the class of shareholders. Indeed, the commonness of share-holdings simply indicates that risk, ideally, should be socialized in a way that it has been in New Zealand – through statutory accident compensation funded through the taxation system.[350]

Liability should be imposed upon shareholders without the need to establish that they have either control over the company or the capacity to control. The reasons for this include: the difficulty of settling upon an adequate definition of control;[351] the potential for evasion of controller liability by splitting up holdings in particular companies; and the disincentive that this would provide to active engagement by shareholders in their companies.

There are further reasons for rejecting the need for control as a basis of liability. The nature of company ownership is changing. As already discussed, an increasing proportion of shares in major companies are now beneficially owned by institutional investors rather than by natural persons.[352] Their shares are often registered in the names of custodians and voting rights are exercised by advisers such as Risk Metrics.[353] This means that it is increasingly incoherent to insist upon control as a criterion for shareholder liability. It also means, with respect to major companies, that the first liability 'hit' usually will fall upon institutions rather than natural person shareholders. It will be a rare event indeed for the investors in major companies to become liable for the personal injuries caused by their companies. These comments do not apply, of course, with respect to smaller (and perhaps many medium size) companies.

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[350]See, Kutz, Complicity – Ethics and Law for a Collective Age, P. 247.
[351]Nina A. Mendelson, A Control-Based Approach to Shareholder Liability, P. 1290.
[352]See, Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better Company: Shareholder engagement and participation in Australia,* Commonwealth of Australia, 2007, P.6.
[353]Id, P. 3-4.

3.8.4. Sollar's Proportional liability[354]

Sollar argued that each shareholder would be liable for the excess of liabilities over the corporation's assets to the extent of the proportion of her/his shares to the total number of shares outstanding.[355] This is based on the principle of gains and losses in that those who have a chance of receiving arbitrary gains resulting from actions deliberately taken in their behalf must also be subject to the possibly of bearing the arbitrary losses that might be associated with such actions. The criticism that can be raised in this regard is that this theory does not address the liability of members beyond the extent of the proportion of her/his shares to the total number of shares outstanding.

3.8.5. Witting's Modified Limited Liability[356]

The doctrine of limited liability limits the risks of business failure and insolvency for shareholders. However, this is not to say that limited liability limits the overall risks of business decline and insolvency.[357] If anything, it increases the total amount of risk of harm by creating a moral hazard with respect to declining companies. The doctrine of limited liability externalizes risks and the most vulnerable to such risks are tort claimants.[358]

The effect of a modified rule of limited liability for personal injuries would be to create a form of strict liability for shareholders with respect to the wrongs of the companies in which they invest. This is to say that shareholders could be held liable for their companies' causation of personal injuries regardless of fault.[359] For some, this might be a troubling thought. However, the free will paradigm,[360] which insists upon fault in the doing of a wrong, does not provide the only basis on which tort liability might be imposed.[361] The focus within that paradigm is upon one person – the doer of a wrong. However, there are substantial arguments for viewing the commission of a tort

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[354]Sollars, An Appraisal of Shareholder Proportional Liability, PP. 329-345
[355]Ibid
[356]Christian Witting, Liability for Corporate Wrongs, PP. 113-142
[357]Halpern et al., 'An Economic Analysis of Limited Liability in Corporation Law', P. 129
[358]Christian Witting, Liability for Corporate Wrongs, P. 136
[359]Cane, Responsibility in Law and Morality, P. 82.
[360]For the origins of the theory, see, James Gordley, *Foundations of Private Law: Property, Tort, Contracts, Unjust Enrichment,* 2006, P. 14-31.
[361]'Volition is one ground of responsibility, but not the only ground': Meir Dan-Cohen, 'Responsibility and the Boundaries of the Self', *Harvard Law Review,* 1992, Vol. 105, P. *959* and 961.

through a wider lens. Thus, Cane has argued that '[r]esponsibility in civil law is two-sided, concerned not only with agent conduct, but equally with the impact of that conduct on others… Responsibility in civil law is always *to* someone as well as *for* something'.[362] An important line of thought suggests that 'the basic measure of civil law remedies is the impact of the proscribed conduct on the victim, not the nature of the agent's conduct or the quality of the agent's will'.[363]

A strict liability standard coheres better with the idea of collective responsibility for harms than does negligence or other fault-based standard.[364] 'Only strict liability will force each [responsible entity or person] to consider the full social cost of its actions in determining' the level of activity to undertake.[365] Strict liability provides strong incentives for those responsible to either cease the conduct of a particular activity[366] or to put in place policies and procedures that actually work in preventing wrongs occurring. Duty-based regimes are less effective because they require merely that reasonable action be taken.

In recent decades, United States' tort rules have been formulated so as to impose greater levels of collective responsibility on organizations. The best known examples of this are strict products liability and attributions of causal contribution to injury based on market share for drugs and other substances.[367] This focus upon the organization and shared responsibility in attributions of liability reflects the fact that organizations are comprised of multiple persons and are 'actively engaged in the manufacture of risk'.[368] 'The complexity of an organization means that mistakes or misconduct in one part of it may have serious repercussions elsewhere; anomalies may be systemic and relate to poor coordination and communication between different parts of a company'.[369] Various incentives must be created to ensure that risks are properly assessed in the

[362]Peter Cane, *Responsibility in Law and Morality,* 2002, P. 42 and 50.
[363]Id, P. 189.
[364]Kenneth Abraham, 'Individual Action and Collective Responsibility: The Dilemma of Mass Tort Reform', *Virginia Law Review,* 1987, Vol. 73, No. 12, PP. 823-864, at P. 845, 854-5.
[365]Jennifer Arlen and Reiner Kraakman, 'Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes', *New York University Law Review,* 1997, Vol. 72, No. 2, P.687, 692.
[366]Cane, Responsibility in Law and Morality, P. 84.
[367] See Ariel Porat and Alex Stein, *Tort Liability under Uncertainty,* 2001.
[368]Ulrich Beck, *Risk Society: towards a new modernity* (1992), quoted in Bridgett Hutter and Michael Powers (eds), *Organizational Encounters with Risk*, 2005, P. 3.
[369]Bridgett Hutter and Michael Power, 'Organizational encounters with risk: an introduction' in Hutter and Power, 2005, P. 198, 14. These matters are encapsulated in the idea of 'system interconnectedness': ibid 17.

different components of the whole and that management properly regulates the creation of risk by the organization.[370]

The efficacy of strict liability might also be seen in the operation in Australian law of the non-delegable duty. The non-delegable duty is a doctrine of strict liability that seeks to ensure that organizations adopt proper systems, processes and procedures for averting risks of personal injury with respect to particularly vulnerable groups such as school children and hospital patients.[371] In the case of the proposal advocated by this paper, incentives would be provided to individual shareholders. Modified limited liability for personal injuries would provide an incentive for shareholders to ensure that the managers of their companies take action by putting in place effective policies and procedures.

There are other fundamental points to note about the tort system of compensation which are often neglected in the debate about the liability of companies and their individual constituents. In cases like James Hardie, claimants are seeking redress for their personal injuries and defendants are seeking to protect their financial interests. Tort law is characterized by a comparative contest over liability.[372] When a claimant sues a defendant, judgment will be for either the claimant or the defendant – there are no other possibilities. Tort theory suggests that the claimants' interests are worthy of greater protection than shareholders' financial interests.[373] Tort protects to a very high degree interests in the body and property.[374] Although damage to property can generally be made good by a monetary payment, debilitating injuries have an impact upon lives that can never really be made good in the same way.

There are reasons against imposing liability solely on the basis of the types of interest at stake in a comparative contest over liability. But such liability might be imposed where the plaintiff has

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[370] Ibid 9.
[371] See Christian Witting, '*Leichhardt Municipal Council v Montgomery*: Non- Delegable Duties and Roads Authorities', *Melbourne University Law Review,* 2008, Vol. 32, P. 332.
[372]Stephen Perry, 'The Moral Foundations of Tort Law', *Iowa Law Review,* 1992, Vol. 77, P.449
[373] William Lucy, *Philosophy of Private Law,* 2007, P. 216ff.
[374]For an explanation of why this kind of case can be seen as being of 'strict liability' see Peter Cane, *The Anatomy of Tort Law,* 1997, P. 130. It should also be noted, in the context of organizations, that strict liability doctrines such as the breach of non-delegable duty apply in cases of bodily injury or the threat thereto. See Christian Witting, 'Breach of the non-delegable duty: Defending Limited Strict Liability in Tort', *University of New South Wales Law Journal,* 2006, Vol. 29, No. 1, P.33.

suffered personal injury and the defendant faces the loss of a mere financial interest but has played an important function in the conduct of the injuring activity; where his or her 'actions are modulated to the demands of a collective end'.[375] As noted above, the shareholder has an important function in the company – in financing its operations.

The argument made herein specifically rejects the need for shareholder control over corporate wrongdoing as the basis for their liability. Ordinarily, the law does not refrain from imposing responsibility on persons simply because they lacked sufficient control over an activity.[376] 'If responsibility depended on control over all aspects of our conduct and its consequences, we would never be (fully) responsible for anything'.[377] Vicarious liability, for example, does not depend upon a substantial causal relationship between employment and tort. The test for liability is comparatively lax – the tort merely needs to have a sufficient connection with the employment.[378] Indeed, vicarious liability has been imposed in circumstances where employers have done all that is reasonable to prevent employee wrongdoing.[379] The similarity between the kind of shareholder liability proposed and vicarious liability is significant – in both cases there is an expectation that the principal, although not directly engaged in the activities in question, will profit from them.

Of course, control features heavily in the theories of shareholder responsibility that have been surveyed. For those who insist upon the salience of control, shareholders are more likely to have a certain kind of control over wrongdoing than non-company employee tort claimants.[380] That control subsists in the putting into motion of, or the support for, an enterprise that injures. Depending upon the context in which a harmful interaction arises, this may be more significant than the control exercised by the tort claimant – especially in cases where the claimant is a minor.[381] Again, this points to a similarity between the vicariously liable employer and the shareholder. Just as the employer puts an employment activity into motion, so too do the

[375]Kutz, *Complicity – Ethics and Law for a Collective Age*, P. 162-3.
[376]See John Fischer and Mark Ravizza, *Responsibility and Control: A Theory of Moral Responsibility,* 1998, P. 43.
[377]Cane, *Responsibility in Law and Morality,* P.42 and 67.
[378] Ibid.
[379] Ibid.
[380] Ibid.
[381] Ibid.

shareholders put a business activity into motion.[382] However, the point of this paper is that control is not necessary in imposing liability for personal injuries upon shareholders. Any exercise of control by shareholders will merely strengthen the arguments for redress made.[383]

A move to a pro-rata unlimited liability regime would need to be accompanied by alteration to the rule regarding priority of payments on a winding up of the company.[384] This is to ensure that the law does not favour corporate insiders over outsiders such as tort claimants[385] and that vulnerable tort claimants have the greatest opportunity to obtain redress.[386] Tort claimants should rank first in their entitlements (sums set aside for the winding-up of the company apart) – that is, before secured creditors.[387] This is on the basis that compensation for personal injury is more important than are the purely financial interests of secured creditors.[388] Where the injured include both outsiders and company employees, the former should have the first opportunity to satisfy their claims.[389] This is on the basis that employees can readily be identified with the company and the torts that it commits, given their functional roles within the organization.[390]

LoPucki has asserted that an alteration to the rules of priority would have readily predictable results: 'without priority, mortgage and other secured lending would be unavailable. Lenders would withdraw from the market…'[391]However, this seems unlikely with the run-of-the-mill loan agreement, where there is no reason to fear tort liabilities. In cases where such fears are legitimate, one of two responses are likely.[392] In the case of moderately risky projects, the creditor will build the expected cost of defaults in to contract prices. In more extreme cases, government-guarantees may be required (as explained in the next section).

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[382] Ibid.
[383] Ibid.
[384]See also James White, 'Corporate Judgment Proofing: A Response to Lynn Lo Pucki's, '*The Death of Liability*' *The Yale Law Journal* , 1998, Vol. 107, P. 54-5. [Here in after, White, 'Corporate Judgment Proofing: A Response to Lynn Lo Pucki's 'The Death of Liability']
[385]See Helen Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors', *Oxford University Commonwealth Law Journal,* 2007, Vol. 7, P.93, 109.
[386]Christian Witting, Liability for Corporate Wrongs, P. 139
[387] Ibid.
[388] Ibid.
[389] Ibid.
[390] Ibid.
[391]See White, 'Corporate Judgment Proofing: A Response to Lynn Lo Pucki's, 'The Death of Liability', P. 11.
[392] Ibid.

Thus, from all the above discussions it can be understood that all the theories other than Witting's modified limited liability or strict liability theory are less favored when compared with Witting's theory for the reasons mentioned above.

CHAPTER FOUR

4. CONCLUSION AND RECOMMENDATION

4.1. Conclusion

As per the empirical studies conducted on Addis Ababa (Akaki Kality Industrial Zone), Bahir Dar (Bahir Dar (Dieve Empex Enterprise) and Habesha tanneries), and Wukro in Tigrai (Sheb Tennery), industries in Ethiopia are releasing their effluents in to the rivers which are being used for different purposes such as washing, drinking and for other domestic activities thereby causing different health problems on the nearby residents. The industrial effluents also make animals to suffer direct health impacts such as skin rashes and sores. Consumption of vegetables is also the other problem that is affecting the residents' health since the effluents pollutes the land/soil on which the vegetables are grown. All of these problems are among the practical grounds that require adequate legal remedies to tort creditors for the wrongs caused due to pollution or release of wastes by companies.

There are some provisions under the Ethiopian laws which have a bearing on the grounds that give rise to the liability of shareholders to company's tort creditors though the law does not make shareholders liable for the torts of their companies as they reap the benefits of risky investments. Though one of the mechanisms of protection of tort creditors is prioritizing their claims in the secured credit systems, let alone holding all shareholders liable for the wrongs committed by their companies, the Ethiopian Commercial law does not even prioritize the claims of tort creditors on the winding up of the company.

As regards bankruptcy, the Commercial law does not address for the liability of shareholders by the mere fact that they are shareholders if they did not engage in the management of a company which later on become bankrupt. Similarly, the Ethiopian Commercial law does not also address the liability of founders (assuming that they are shareholders) by mere fact that they are members if they do not engage in the commitments which are not valid in the eyes of the law or the one that can be approved by the general meeting of subscribers. For instance, forming a Share Company with less than the minimum capital required will result in violation of the law. The same is also true for establishing a company with less than the minimum numbers of persons required by the law to form a company, etc. In relation to environmental protection related rules

(such as FDRE Constitution, Administrative laws, the Ethiopian Civil Code, and Criminal law) as well, there is no provision which provides for the liability of shareholders to tort creditors (due to the fact that they have assumed the status of shareholders) for pollution or waste of company's in Ethiopia.

From all the doctrines pertaining to the liability of shareholders for company's torts, it can be understood that all the theories other than Witting's modified limited liability or strict liability theory are less favored when compared with Witting's theory. For instance, Mendelson's control based approach cannot be favored since it re-introduces the need for costly monitoring by shareholders of management and of each other. This approach also offers no compensation for tort victims in cases where there are no controlling shareholders. Similarly, Kutz's approach is also open to critics on the ground, among others, that shareholder liability does not depend upon any ex ante intention or ex post proof of fault in the person to be made liable.

4.2. Recommendations

1. Since the legal protection of tort creditors begins with by prioritizing their claims in the secured credit system, the Ethiopian bankruptcy law should prioritize the claims of tort creditors over all other claimants in the winding up of the company. To this effect, the existing bankruptcy provision has to be amended in such a way that put tort claimants at the top or first rank in the queue of order of payment of claims on the winding up of the company.

2. Then, if the claims of tort creditors remains unsettled or becomes in excess of the assets of the company which is at fault after applying their priority right, it is appropriate to make all shareholders – corporate and natural – strictly and personally liable for personal injuries inflicted (as a result of commission of the grounds that give rise to liability of shareholders for company's torts) by companies in which they hold their shares. The justification for doing so is not in the exercise by a shareholder of control; but in the facts that the shareholder is a company insider with a distinct function to play in arming the company with capital, that the claim of the injured tort victim is of a higher order than any financial loss to be borne by the shareholder, that shareholders, no less than other potential tort defendants, may attempt to evade tort liability by hiding assets or by exploiting the limitations on personal liability offered by bankruptcy law and that when a person has the right to receive benefits that might result from actions that are taken

in order to benefit him, it is fair that the effect of any harms that might occur from attempts to secure such benefits also be distributed to that person. Thus, the injured tort victim should have the right to identify the shareholder with the company and have the better claim in a comparative contest over responsibility for loss. Under this part of the general recommendation, the following specific recommendations are recommended:

- All shareholders have to be made strictly liable and this should be provided in the Commercial Code as an exception to the general rules of the doctrine of limited liability. Thus, all shareholders should be liable unlimited in order to satisfy the claims of tort creditors from their personal pockets. In this respect, the strict liability of shareholders for their company's torts should be provided in the part of extra-contractual liability law dealing with strict liability as this is a matter of tort law.
- The liability should apply only in favor of tort creditors who are affected by the faults of company's and does not totally apply to contractual creditors,
- The liability should not apply to all grounds. It should rather apply only on those specific grounds that give rise to tort liability of shareholders for their company's torts such as liability for hazardous products, environmental hazards such as oil spills and release of toxicants, dangerous chemicals, etc.

3. The liability should be pro-rata rather than joint liability because the latter could potentially result in a single shareholder assuming the liabilities of an entire corporation – depending on the financial status of the other shareholders. Theory suggests that it would then become imperative for shareholders to monitor each other – and for decisions to invest to be made on the basis of shareholder wealth. The potential also arises for shares to be valued differently according to the wealth of each owner.

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