JIMMA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE

SCHOOL OF LAW

ANALYSIS OF THE MAJOR LEGAL PROBLEMS ASSOCIATED WITH LIMITED AND UNLIMITED LIABILITY OF BUSINESS ORGANIZATIONS UNDER ETHIOPIAN LAWS

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Approval Sheet

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DECLARATION

I, the undersigned, declare that the thesis entitled '**Analysis of the Major Legal Problems Associated with Limited and Unlimited Liability of Business Organizations under Ethiopian Laws'** is my original work and has not been presented for a degree in any other university and that all sources of materials used in the thesis have been duly acknowledged.

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January 2021

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ABSTRACT

Limited liability, a very crucial concept in today's business world, which bases the distinct personality of the business entity from the personality of those who own it, has become an indispensable part of contemporary corporate laws. Thus, the concept of limited liability is the first to be mentioned among the core characterizing features of companies. But, these days the concept is also becoming familiar in partnership firms. In both corporations and partnerships, it enables the owners limit their liability only to the extent of what they have already invested in the firm. In Ethiopia too, this concept of limited liability have been characterizing Companies in Ethiopia since the coming in to force of the 1960 Commercial Code, although, it is surrounded by legal problems irrespective of its sensitivity. Thus, the objective of this thesis is to doctrinally analyze the major legal gaps associated with limited and unlimited liability under Ethiopian laws of Business Organizations and to answer what major legal problems are there associated with limited and unlimited liability and thus to answer whether the Commercial Code balances interest of the corporate members and that of creditors. Accordingly, the research shows that there are certain legal problems associated with limited liability of corporate shareholders, in relation to sources of limited liability, on how to mitigate the moral hazards caused by limited liability to creditors, on how to impose unlimited liability, period of limitation within which rights has to be claimed and on the treatments given to firm owners in one hand the creditors on the other hand while dealing with limited liability. Finally, the writer recommend on eight major points with a view to provide a solution to the major legal problems that surrounds limited and unlimited liability so identified by this research and also to make a right balance between the two competing interests of creditors and the firm owners while regulating liability of the firm.

Keywords: *Business Organizations, Liability, Limited Liability, Unlimited Liability, Separate Legal Personality*

Acronyms and Abbreviations

AG (AktG): German Stock Company

AOA: Article of Association

Art: Article

BGB: German Commercial Code

BO: Business Organizations

BoD: Board of Directors

ETB: Ethiopian Birr

GmbH: German Private Limited Company

LLP: Limited Liability Partnerships

MIDROC: Mohammed International Development Research and Organization Companies

MOA: Memorandum of Association

NBE: National Bank of Ethiopia

OMPLC: One Man Private Limited Company

PLCs: Private Limited Companies

SCs: Share Companies

UK: United Kingdom

UPA: Uniform Partnership Act

USA: United States of America

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CHAPTER ONE

1. INTRODUCTION

1.1. BACKGROUND OF THE STUDY

Business organizations, especially corporations, are distinct entities from their members and enjoy rights and are subject to duties which are quite different from that of their members[1]. Thus, business organizations can sue and be sued, own property and enjoy a continuous existence separately from their members. In addition to these few features, business organizations could be formed as a limited liability business organization or as unlimited liability business organization by having stated this fact clearly on their formative documents[2]. Thus, if a business entity is formed with an unlimited liability it means that, members of the business entity are guarantors of the firms' obligation without restriction on amount and, on the other hand, if a business entity is formed as a limited liability firm, then, its members will only be liable to the extent of the nominal value of share they held in the firm.

The limited liability rule that considered as a fundamental principle of corporate law[3] has been defined as "a liability restricted by law or contract; esp., the liability of a company's owners for nothing more than the capital they have invested in the business[4]." More clearly, limited liability is also defined as;

> "a legal protection limiting each shareholder to the par value of fully paid-up company shares to cover the financial liability of the company's debts and obligations in privately or publicly owned corporations. As a legal entity, the company itself is liable for the rest. It is also known as limited personal liability[5].

In relation to corporate law, limited liability has also been defined as the principle whereby a member of an incorporated company will not be held liable for the debts and other liabilities of

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[1] L.C. B. Gower, *Gower's Principles of Modern Company Law,* 5th Ed. Sweet and Maxwell London 12 (1992). Cited on Igho Lordson Dabor, *Limited Liability: A Pathway for Corporate Recklesness*? A PhD Dissertation Submitted at the University of Wolverhampton, (2016), notes 31, with emphasis

[2] Igho Lordson Dabor, *Limited Liability: A Pathway for Corporate Recklesness*? A PhD Dissertation Submitted at the University of Wolverhampton, 2 (2016)

[3] Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 Univ. Ch. L. Rev. 89, 89 (1985)

[4] Bryan A. Garner, Black's Law Dict. West Publishing Co. St. Paul 8th Ed. 2678 (2004)

[5] https://thelawdictionary.org/limited-liability/

the company beyond a prescribed amount, literally, the nominal value of his/her share[6]. In the contrary, the term unlimited liability describes a scenario or situation in which shareholders of a company and partners in partnership those who are obligated for paying debts of their firm be subjected to unlimited responsibility[7]. Thus, it means that, the business owners are personally responsible for the debts of their firm in case the business runs out of money to pay back its debts.

What is more, limited liability is perceived among the various stakeholders differently. Thus, limited liability of the shareholders, in the thinking of the general public, is described as an attribute that is most closely connected to the modern business entities[8]. For investors, limited liability is what permits them to restrict liability that could arise only to the amount of money they originally invested in the firm. In the contrary, to the creditors, it is at worst a necessary evil, or, perhaps an obstacle to be by-passed by requiring the personal liability of others to be added to corporate liability in specific instances as a condition to the granting of credit[9].

Thus, the principle of limited liability is an established principle in contemporary business laws of many jurisdictions states and is perceived differently among numerous stakeholders, starting from the firm to its creditors and from lawyers to economists. The rule is told to have its justification that firms have separate legal personality different from its owners/shareholder/ and hence, the firm's property as well as the firm itself, to be managed by persons other than the owners. As a reward of their failing to participate in administering and managing the firm, the owners are entitled to a limited liability. This means that they will not be held responsible to the firm's liability for an amount exceeding what they have already invested in the firm.

Limited liability of owners and managers of the firm is one among the five core features which continues to characterize the corporate form of business, even today[10].This rule of limited

[6] Supra note 1, at 12

[7] Limited and Unlimited Liability, Encyclopedia.com, https://www.encyclopedia.com/finance/encyclopedias-almanacs-transcripts-and-maps/limited-and-unlimited-liability, accessed on Nov, 20, 2020

[8] Frederick G. Kempin, Jr, *Limited Liability in Historical Perspective*, American Business Law Association Bulletin, p. 11, with emphasis

[9] Id

[10] Henry Hansmann and Reiner Kraakman, Essay: *The End of History of Corporate Law*, 89 Georgetown L. J. p. 439, 439-440, (2001) Henry and Kraakman listed five core feature of companies; (1) full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm, as distinct from the firm's owners; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.

liability is a form of 'owner shielding' and is a component of legal personality[11]. But does not, however, necessarily provides for how the interests of other participants in the firm-such as employees, creditors, other suppliers, customers, or society at large-will be accommodated[12].

Thus, based on how the concept of limited liability has been incorporated in various corporate laws and how these laws deal with the interests of shareholders and stakeholders of the firm, there are two models of corporate law. The shareholder oriented model and or stakeholder's model[13] . When liability is highly limited it tends towards the shareholders approach and when it is unlimited and grounds for disregarding limited liability of shareholders are wide, thus it tends toward the stakeholders approach.

The first one, shareholders model, states that ultimate control over the corporation should rest with the shareholder class. The managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders. Other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance[14].

On the other hand, in case of the stakeholder's model, it is argued that, stakeholders may be subject to opportunistic exploitation by the firm and its shareholders if corporate managers are accountable only to the firm's shareholders, therefore, corporate law must have to ensure that those who run the firm are considerate of the stakeholder interests as well[15].

The stakeholder model devised two models of protecting stakeholder's interest in the corporation. The first one is a 'fiduciary' model in which the board of directors functions as a neutral coordinator of the contributions and returns of all stakeholders in the firm[16]. The second model is a 'representative' model in which case two or more stakeholder constituencies appoint representatives to the board of directors. This is to enable them elaborates policies that maximize

[11]Reinier Kraakman et al, *The Anatomy of Corporate Law a Comparative and Functional Approach,* 2nd ed. 34 (2009), see also Henry and Kraakman, *Essay: The End of History of Corporate Law*, The Georgetown Law Journal, p. 440,

[12] Supra note 10, at 441

[13] Id 10, at 441-443

[14] Id, at 441

[15] Id, at 447

[16] Id

the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table[17].

Despite what has been said above, an entitlement of the shareholders in companies or partners in partnerships is not an absolute right, however. The jurisprudence in many countries laws shows that limited liability right of shareholders and partners can be limited and they can be held liable to the firms by piercing corporate veil of the firm, in the interest of safeguarding and balancing creditors as well as other stakeholder's interests.

On the other hand, when the firm does not have a separate legal personality, in unlimited liability firms, owners of such firms will directly be responsible to the firm's liability. This is mainly based on the reason that they are given the right and have participated in management of the firm and hence they could have averted the fact causing the liability. However, even when the owners of the firm are given the right to manage the firm and having shared same legal personality with that of the firm, they may be entitled to enjoy a limited liability. This is again made basically so as to protect the interests of the owners and keep its equilibrium with that of the creditors and other stakeholders.

What is more, based on whether an owner of a given firm is entitled to limited or unlimited liability, firms are being classified as limited or unlimited liability firms. These can take the form of companies or corporation as termed in some jurisdiction and or partnerships, both taking different forms. Accordingly, in an unlimited-liability firm, such as sole proprietorships and certain limited partnerships, the firm's principals are financially liable for the debts of their firm up to the full amount of their personal financial wealth. On the other hand, owners of limited liability firm can only be responsible to the extent of their contribution in the firm.

Another issue is that what is liability by itself is subject to definition. According to Black's Law Dictionary, liability is defined as 'the quality or state of being legally obligated or accountable or legal responsibility to another or to society, enforceable by civil remedy or criminal punishment[18]'. Therefore, the owners are entitled to limited liability mean; they are not bound to third party for both civil liabilities such as payment of compensation or criminal penalty that may arise from the firm, an entity having a separate legal personality.

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[17] Id, at 448

[18] Supra note 4 at 2676

In Ethiopia too the concept of limited and unlimited liability is introduced as early as the 1960, when the current commercial code was adopted. The Commercial code in its provisions dealing with business organizations, Book II, provide firms with limited liability (such as Share Companies, Private Limited Companies and for partners in limited partnership) and unlimited liability firms such as General Partnership and Joint Ventures[19].

1.2. STATEMENT OF THE PROBLEM

Limited liability, as a legal concept, is recognized in Ethiopian for the first time under the 1960 Commercial Code. The concept, under the commercial code, is understood to be a legal privilege which is given to shareholders in company and partners in some partnerships due to the operation of the principle of separate legal personality and separation of ownership and management of a firm.

Although there are certain situations by which this right to enjoy limited liability itself may be limited, whether the Ethiopian law balances the interest of creditors in one hand and that of owners of the firm on the other hand is, however, an issue that is not yet studied. The commercial code lacks clarity as it does not, first, define and clearly stipulate what liability is and it is also ambiguous as to what kind of liabilities are to be limited and not and in what circumstances.

Whether limited liability protection is extended or not to corporate shareholders in the case of company holdings and what would be its implication on the interest of the firm's creditors is not also clearly stated under the law. Thus, it is an issue whether liability in such scenarios should be limited as a matter of rule and also whether such corporate shareholders be treated as individual shareholders and if so whether it affects or not the interests of stakeholders demand answers.

Besides, while most commercial codes have adopted either the shareholders model (protects shareholders interest at most) or the stakeholder's model (tries to balance interest of stakeholders as well)[20], it is questionable as to which one has been clearly adopted under Ethiopian laws. Therefore, identifying the model so adopted by the code and analyzing it in terms of available jurisprudence on the area is another issue that triggers a study on the matter.

[19] Commercial Code of the Empire of Ethiopia Art 212, Proc No. 166, Neg. Gaz. Year 19, no. 3 (1960)
[20] Supra note 10

It is equally important, as to the recognition of the rule of limited liability itself, to provide with a way out for incase those firms enjoying limited liability have engaged in a risky endeavors to the extreme detriments of the firms creditors interest. But it is yet to be discovered as to what are the way outs and the remedies provided under Ethiopian laws on this matter. As an example, on this point, in Ethiopia there is no mandatory insurance fund. It is only recently that the National Bank of Ethiopia Comes with a draft regulation to establish deposit insurance fund concerning creditors of BOs engaged in banking services. In relation to this, one may forward that piercing the corporate veil of such firms could be a way out. However, in Ethiopia, the commercial code does not, even, explicitly call for piercing corporate veil and, the statutory grounds of piercing the corporate veil, through implied inference, are claimed to be limited[21]. Yet, Ethiopian Courts are not proactive enough in applying the doctrine of piercing the corporate veil out of the statutory grounds, like the courts in common law countries[22].

Another attention catching is whether, when corporate veil is pierced and shareholders and partners in partnership are declared to be liable for the debts of the firm, they are to be subject to a *joint and several* or *pro rata liability.* Besides, among these two ways of imposing liability, which is better for the shareholders and also for the creditors is another issue that needs to be uncovered by a study.

In addition to the above stated problems, issues in relation to period of limitation also demands clarity. Thus, it is important to clarify whether there is a period of limitation within which the stakeholders who intends to claim right from the business has to stick to and if any, whether such period is adequate or not, while discussing liability.

On top of these bottlenecks, without having a clear law that set a standard when liability will be limited and not and in what circumstances, the draft commercial code has come up with two forms of business organizations[23], Private Limited One Man Company and Limited Liability Partnership, basically by limiting their liability. Therefore, especially, if these two intended modes of business organizations are to be realized in a condition where there is no a clearly

[21] Endalew Lijalem Enyew, *the Doctrine of Piercing the Corporate Veil: Its Legal and Judicial Recognition in Ethiopia, 6* M L R, 77, 113-114, (2012)

[22] Id

[23] The Draft Commercial code of Ethiopia (2012), under articles 257-270 and 505-540 deals with Limited Liability Partnership and Private Limited One Man Company.

stated law as to when they will enjoy limited and unlimited liability it would negatively affect creditors. The problem in relation to these two newly coming forms of business is twofold; one they are new to the Ethiopia's legal system, and thus not tested practically, and secondly, giving limited liability to a business firm with single or very small members, could possibly endanger the interests of the outsiders, creditors and employees. Besides, when a new form of entity is to be adopted, gaps and uncertainties' in the law are certain and thus demands study.

Finally, in a scenario where, according to studies, the limited liability is affecting promoters (investors) choice of forms of establishing firms, and it even determines survival and profitability of firms, to study the major legal problems associated with limited and unlimited liability of BOs under Ethiopian laws is crucial.

1.3. RESEARCH QUESTIONS

Thus, stepping on these legal issues, the study answers the following main research questions;

1. What are the major legal gaps and inconsistencies in Ethiopian laws governing liability of Business Organizations?
2. Does the Ethiopian laws governing liabilities in BOs balance the interests of shareholders/partners and stakeholders such as creditors, employees and customer? If not, what mechanisms should be introduced in to Ethiopian laws governing business organizations to balance these two interests?
3. What potential lessons Ethiopia can draw from the experiences of other jurisdictions?

1.4. OBJECTIVES OF THE STUDY

1.4.1. General Objectives

The general objective of the study is to investigate and identify the major legal problems associated with limited and unlimited liabilities of businesses organizations under Ethiopian laws.

1.4.2. Specific Objectives

The specific objectives of the study are:

- To explore the major legal gaps in the Ethiopian law of business organizations in relation to limited and unlimited liabilities of business organizations;
- To clarify how corporate shareholders are treated under Ethiopian laws in relation to limited liability;
- To assess the forms of imposition of liability under Ethiopian laws governing liability of BOs;
- To assess how the Ethiopian law of business organizations treat interests of creditors and stakeholder while limiting liability of the shareholders;
- To uncover what mechanism should be introduced to the laws governing BOs in order to balance the competing interest of the corporate members and that of stakeholders; and
- Exploring if there is any potential lesson Ethiopia could learn from other jurisdictions.

1.5. SIGNIFICANCE OF THE STUDY

In terms of significance, the study could have at least the following triple purposes to serve. One, it may serve the legislators as an input to make an informed decision in relation to liability of business organizations, especially since the commercial code is under its final revision and the legislators are seeking experts opinions. Secondly, it will serve as a referral guide to the business community in making choice of forms of business organization as it will tends to make clear situation in which liability is limited and not for each type of business organizations. Thirdly, the research paper will add in to an existing literature as well as knowledge in the area and can serve as a fruitful reference for further studies focusing on liability of business organizations.

1.6. RESEARCH METHODOLOGY

For the successful accomplishment of the study, the researcher employs a qualitative doctrinal legal research method with an element of comparative and theoretical discussions. Therefore, the study uses the existing laws as primary sources of data and analyzes them in order to answer its research questions and achieve its objectives. The study uses secondary sources of data such as books, journal articles, working papers and internet sources to review the theoretical concepts in relation to limited and unlimited liabilities of business organizations. As a tool of data collection the researcher has analyzed laws and made document reviews. It has an element of comparison in the sense that in the discussion literatures and materials as well as laws of experienced and

countries with a well-developed legal system have been used to make the study comprehensive and realistic. To this end, the researcher make use of the French and the German laws from the civil law legal system from which, historically, our commercial code has taken a lot and from the common[24] law legal system the researcher referred to the laws of USA, and that of UK's Company act, because they are a well experienced and well developed in corporate laws[25]. Besides, although the commercial code is based on continental law principles, it has amalgamated continental and English rules on many substantive legal points[26]. Thus, using laws of these countries as a source would be justifiable.

1.7. SCOPE OF THE STUDY

Scope wise, the study generally focused on analyzing the major legal problems associated with the limited and unlimited liabilities of business entities recognized in Ethiopia. It emphasized on analyzing and examining the law and proposing as to how to narrow down the gaps in the law. In doing so the study briefly looked at the theoretical issues of legal personality, limited liability, piercing corporate veil and shareholders and stakeholders primacy rules. However, for the sake of clarity, the study has also examined the draft commercial code, to some extent, especially in relation to liability of the newly proposed forms of business organizations, One Man Company and Limited Liability partnerships. As such, the scope of the study is limited to analyzing, in line with the existing theories and legal principles, limited and unlimited liability under Ethiopian business organizations, both companies and partnerships firms. However, Ordinary Partnership is excluded from the ambit of this study because it is always non-commercial by its nature[27], hence resembles, more or less civil society organization, rather than BOs[28]. What is more, sole

[24] Katharina Pistor et al. *The Evolution of Corporate Law: A Cross Country Comparison*, 23 U. Pa. J. Int'l Econ. L. 791, 799 (2002) While England and the United states represent the core countries of the common law legal family; Germany and France represent those of the civil law families

[25] Peter Winship, *Background Dociments of the Ethiopian Commercial Code of 1960,* Faculty of Law, Haile Silase I University, iii (1974). On the introductory part of the background documents of the Ethiopian commercial code Peter Winship has clearly stated that the Ethiopian commercial code has a foot on both civil law and common law camps. Winship added that although the commercial code is based on continental law principles, it has amalgamated continental and English rules on many substantive legal points. Thus, using laws of these countries as a source would be justifiable.

[26] Id

[27] Supra note 19, arts 5, 10 & 227

[28] This is because, an entity or a person who does not engage in economic activities as listed under art 5 of the commercial code professionally and for gain cannot be considered as trader and does not fulfill the element of business as defined under Art.,124 of the code.

proprietors, because they are individual business persons, and not bodies, cannot be considered as a BO and hence, excluded from the scope of this study.

1.8. LIMITATIONS OF THE STUDY

As there can be no research work undertaken without challenges and limitations, this researcher has faced certain limitations. Firstly, as the issue is hardly researched, the researcher faces lack of domestic literatures on subject matter. Secondly, lack of strong internet connection was also a limitation to the study given the current situation of the country. Thirdly, the researcher has faced time shortage. However, the researcher has used all the resources he have and able to manage to finalize the paper within the time set and also able to collect the necessary literature with the help of good friends and solve the internet connection by getting a private WI fi network.

1.9. STRUCTURE OF THE STUDY

The research paper has four main chapters and different subtopics. Accordingly the first chapter deals with introductory matters of proposal of the study. It covers background of the study, statement of the problem, research questions, objectives of the research, significance, scope and limitation of the research as well as research methods, organization of the paper and also ethical consideration while conducting the research. The second chapter deals with a general conceptual overview of the concept of limited and unlimited liability. It discusses and defines limited and unlimited liability, provide a historical account of limited liability, and explain the conceptual and theoretical overview on limited and unlimited liability. The last but not the least sub topic of the second chapter briefly introduces BOs under Ethiopian law in relation to their nature of liability. The third and the main chapter of the research have discussed and provide a bird's eye view elaboration on the major legal issues associated with limited and unlimited liabilities under Ethiopian law of BOs. Accordingly it makes clear issues such as limited and unlimited liability vis-à-vis Company holdings; period of limitations, limited liability vis-à-vis its moral hazards, limited liability vis-à-vis its sources, unlimited liability vis-à-vis form of its imposition, and shareholders vis-à-vis stakeholder protection under Ethiopian laws. The fourth and the final chapter, being the final chapter of the study, provides conclusions based on the foundations laid down under chapter two and the discussions made under chapter three and present recommendations.

1.10. ETHICAL CONSIDERATIONS

In conducting the study, the researcher takes all the necessary and due ethical cares to avoid plagiarism, and to cite authorities accordingly.

CHAPTER TWO

2. CONCEPTUAL AND THEORETICAL OVERVIEW OF LIMITED AND UNLIMITED LIABILITY IN BUSINESS ORGANIZATIONS

2.1. INTRODUCTION

The concept of limited liability of the corporate members is known to be a cornerstone of corporate laws both in the Anglo-American and the civil law legal system[29]. Thus, a discussion under this chapter has tried to touch up on the concept of limited and unlimited liability from different perspectives under the two legal systems with a view to lay foundation for the discussions to make under the third chapter.

2.2. LIMITED LIABILITY: DEFINITION AND NATURE

The concept of limited liability is closely related to the concept of separate-legal-entity. Limited liability, thus, presupposes that a limited-liability company and its shareholders are clearly differentiated as distinct legal personalities because the debts of the company are separate from the debts of its shareholders[30]. The concept of limited liability holds different meaning to the various groups of peoples concerned with it. Accordingly,

> "From the point of view of the investor limited liability permits him to submit to the vagaries of fortune solely the amount of money he originally chose to invest in the corporation. To the lawyer limited liability is a rational conclusion to be drawn from the fact that a corporation is an entity; for if it is an entity, it alone is responsible for its debts. To the economist the concept is essential, for without limited liability capital acquisition would be difficult indeed. To the creditor it is at worst a necessary evil, or, perhaps an obstacle to be by-passed by requiring the personal liability of others to be added to corporate liability in specific instances as a condition to the granting of credit[31].

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[29] Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11, J. Corp. L.573, 574 (1986)

[30] Phillip Lipton, The Introduction Of Limited Liability in to The English And Australian Colonial Companies Acts: Inevitable Progression or Chaotic History?, 41 Melb. U L R, 1278, 1280 (2018)

[31] Supra note 8, at p. 11

Thus, the concept of limited liability is a deeply rooted and is laying foundation for both the owners and creditors which are related to the business in one or another way. More importantly, it is said that, there is no attribute of the modern business corporation more closely connected with it, in the thinking of the general public, than the limited liability of its shareholders[32].

The company's separate existence from its owners, that often, is metaphorically described as a veil and this veil serves as a partition between the company and its directors and other members and protects them from the claims of those who deal with the company by limiting the company's debt to its own asset only[33]. The corporate veil, then, is a fundamental aspect of company law and is a protective device for those who exist behind it[34]. Thus, it is the incorporation of a company that casts a metaphorical protective veil over the true controllers of the company, a veil through which the law will not usually penetrate[35].The creation of a corporation establishes a new entity, legally recognized as separate from its participants. This separation offers many advantages, such as facilitating the ownership and transfer of collective property, but its most powerful effect is its insulation of participants from financial responsibility for debts of the enterprise[36]. Although, currently, the concept of limited liability is mostly tied with corporation forms of business, owing to the separation of personality of the firm and its owners, it is not however unique to corporations alone[37]. In other words, it is possible that owners of other forms of business other than corporation such as owners of partnership business firms may also enjoy limited liability even when such separation between ownership and the entity is lacking. The best example towards such reality is the case of limited partnerships, in which case liability of the limited partner is limited only to the extent of his contribution[38]. In the

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[32] Id

[33] Hameed, Irshad, The Doctrine of Limited Liability and the Piercing of the Corporate Veil in the Light of Fraud: A Critical Multi-Jurisdictional Study 8 (Nov. 18, 2012). Available at SSRN: https://ssrn.com/abstract=2282306 or http://dx.doi.org/10.2139/ssrn.2282306

[34] N Hawke Corporate Liability, Sweet Maxwell, London, 126 (2000)

[35] Tan Cheng Han, *Walter Woon on Company Law*, Rev. 3rd Ed. Sweet and Maxwell 62.Availabe at https://www.goodreads.com/book/show/42588645-walter-woon-on-company-law

[36] Robert B. Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, 47Vandrblt.L. R.1, 7 (1994), https://scholarship.law.vanderbilt.edu/vlr/vol47/iss1/1

[37] Supra note 3, at 90

[38] Larry E. Ribstein, Limited Liability and Theories of the Corporation, 50 Md. L. Rev. 80, 81 (1991) Available at: http://digitalcommons.law.umaryland.edu/mlr/vol50/iss1/6

US almost all states has recognized a Uniform Partnership Act (UPA) recognizing the same. The practice is similar in France.

The last important point worth discussing under this topic is that the protection given to corporate owners under the limited liability rule is not absolute. This is mainly because, despite the fact that limited liability is considered to be a privilege conferred by the state as a result of the act of incorporating or forming some other type of limited liability business firms[39], the concept of limited liability as a privilege is objected by some writers. The ground for such objection is that, to make limited liability protection absolute will be unfair to creditors and an invitation to reckless behavior by those doing business in limited liability firms[40]. While the corporate veil normally protects shareholders, officer and directors from liability for corporate debts and obligations, when these individuals abuse the corporate privilege, courts has to disregard the corporate fiction and hold them individually liable.

2.3. A BRIEF HISTORICAL ACCOUNT OF LIMITED LIABILITY

It is the appearance of the *commenda* in the 11th century (in Italy) that is considered as a milestone in the history of limited liability mainly because attempts to trace the genesis of the modern limited liability business organizations back to the *commenda*[41]. The *commenda*, then, was used to finance sea trades and other ventures which were extremely risky[42]. The *commenda* has a distinguishing feature in which some members are entitled to limited liability capital providing members (*passive commendator*) and those who provide commercial skills and manage the venture assume the risks[43]. This makes it similar to the present day limited partnership.

In ancient Rome many corporate entities were de facto rather than de jure, and liability remained unlimited[44] partly because of the fact that most firms were not highly specialized. This was because pressure toward limited liability occurs with a separation of ownership and control[45]. At

[39] Id
[40] Id
[41] William Hilman, Limited Liability from Historical Perspective, 54 WASH. & LEE. L. Rev 615, 621(1997)
[42] Supra note 2, at 10
[43] Id at 11
[44] William J. Carney, Limited Liability, Encyclopedia of Law and Economics, 5620, 659, p. 665 (1999)
[45] Id., See also Bowersock, G. W. "*The Social and economic History of the Roman Empire",* by M. Rostovtzeff, Deadalus 103, No. 1, 15, 25, (1974) Rostvovtzeff states that, these companies were a group of men in the same

a latter dates, the concept of limited liability began to appear among the romans through the concept of *peculium* by which a commercially minded slaves instrumentally serve to do business for their masters incurring liability only to the extent of their assets for a promise of grant of their freedom in return[46].

Although no exact date is available, the principle of limited liability in the US may be traced back to 18th century[47]. As evidence to this statement, Massachusetts enacted five different statutes regulating shareholder liability between 1809 and 1830[48], and by that time, the principle of limited liability was widely recognized in the United States[49].

In England, the concept of limited liability possibly believed to have its root from the commandite partnerships that was originated in Italy[50]. Until the 18th century charters were not granted to limited liability business corporations which were created solely for private profit[51]. By then, corporate charter was but rather given only to religious and public bodies, such as churches, monasteries and thriving towns or boroughs for the public benefit[52]. But later, the concept of limited liability becomes a crucial motive for incorporation and was, statutorily, first introduced by the 1855 Act[53]. This act was repealed and replaced a year after by the 1856 joint stock company act which made formation of joint stock Company with limited liability possible[54].

In France, it was in the early 1807 that the Napoleonic Code de Commerce provides for limited liability for stock corporations[55] and the influence of France limited liability was accepted on the

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profession that felt a natural desire to associate, to meet together and promote their professional interests which were called as "*collegia*, *corpora*, *societates*, *sodalitates*, or *sodalicia and includes educational, religious and government institutions."*

[46] Supra note 41, at 617-619

[47] David S. Baker & V. Scott Killingsworth, *An American View through the Corporate Veil,* 6 INT'L Bus. L. 267 (1978).

[48] Id at 268

[49] William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital,* 43 U. Pr. L. Rev. 837, 847 (1982); See also supra note 29, at 193

[50] Supra note 30, at 1286

[51] Supra note 8, at 12

[52] Supra note 1, at 21

[53] Supra note 30, at 1298

[54] Id, at 1297

[55] Supra note 29 at 596

Continent earlier than in the Anglo-American world[56]. This general enactment of limited liability finds its way to spread through the western world, German, Switzerland and Spain.

Thus, the concept of limited liability, starting from the time of *commenda* and *peculium* in Italy and Rome and then to the time Napoleon *Code de Commerce* of France in 1807, the Massachusetts sets of enactment between 1809-1830 in the US and England's Limited Liability Act and the Joint Stock Company Act of the 1856, has gone through different stages. Thus, limited liability was embraced by the civil law earlier than in the common law countries, US or England[57].

2.4. CONCEPTUAL OVERVIEW OF LIMITED LIABILITY

The limited liability rule which restricts liability of corporate owners for nothing more than their contribution in the firm is to be acquired in different ways. In addition to the fact that it serves a number of advantages the corporate members, limited liability is claimed to be restricted so as to, also protect the interests of the creditors and other stakeholders such as employees and customers. Thus, under this subtopic the nature, how business entities enjoy limited liability, the advantages it offers to the corporate members and its disadvantages to creditors of the firm on the other hand and the mechanisms available to tackle and minimize the negative effects of limited liability have been discussed.

2.4.1. Ways of Achieving Limited Liability

While most discussion of limited liability centers on the use of the incorporation and corporate form to benefit from and limit liability of their shareholders, there are also other ways[58]. Thus, having an alternative to incorporation or choosing a predefined form of entity in the search of limited liability is important in any legal system to protect the business entity and their owners. Accordingly, although it is difficult to tie one of the following methods to either of the two major legal families, generally, in a dealing that is held in business, liability can be limited in any of the following four ways.

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[56] Id
[57] Id
[58] Supra note 44, at 665

2.4.1.1. Express Contracts

It is argued that state incorporation is a mere formality and limited liability is so efficient that had the state not recognized it, market forces would have created somewhat similar entities through the process of free contracting[59]. Thus, firm owners can enjoy limited liability among others through a contractual agreement[60] or which can be regarded as wealth-maximizing for both creditors and owners[61]. Thus, the shareholders in the corporation or the partners in the partnership firm can enter in to a contract with a creditor by which a creditor will agree to look only to the assets of the business firm in case liability may arise. Limiting liability through a contractual agreement is considered to be the oldest liability limiting device and was well known at common law in the joint stock association[62].

2.4.1.2. Incorporation and the Use of Limited Liability Entities

Incorporation has long been the predominant means of limiting liability[63]. By the fact of their incorporation, firms will have a separate legal personality thus, having a capacity to sue and be sued in its own name as separated from its owners. Thus, owners of the firm can enjoy limited liability through incorporation of their business using the various forms of entities, be it among companies or partnership firms, which are made available by the state law[64].

2.4.1.3. Becoming Judgment Proof

The other way of limiting liability in the absence of contractual agreement is by becoming a judgment proof[65]. In other words, owners of a business can escape or at least minimize liability by securing their assets with a friendly creditor so that it can be immunized from seizure by other creditors. What is more, the owners can also remove either themselves or their assets to foreign jurisdictions where enforcement is costly or impossible[66].

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[59] David L Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company*? 51 Okla. L. Rev. 427, 7 (1998)
[60] Supra note 44, at 666
[61] Supra note 38, at 82
[62] Anderson et al., *The Myth of the Corporation as a Creation of the State'* 3 Int. Rev. L. & Eco. 107-120 (1983), cited on William J. Carney, Encyclopedia of Law and Economics, 5620 Limited Liability, 659, 1999, p. 666
[63] Supra note 44, at 667
[64] Id
[65] Id
[66] Alexander J. Cooper, '*Unlimited Shareholder Liability through a Procedural Lens'*, 106 Harvard. Int. L. J. 387, 396-305 (1992)

2.4.1.4. Parent-Subsidiary Strategy

A parent subsidiary strategy is another notable way of limiting one's business firm's liability. In the parent-subsidiary strategy, the debtor company will cut off its valuable assets in an entity other than the one that causes the liability[67]. Thus, in the parent subsidiary strategy, the parent company will incorporate a subsidiary and retain ownership of its stocks and will use the limited liability so created by separation of personality as an advantage of limiting its liability[68].

2.4.2. Functions of Limited Liability in Business Organizations

Limited liability is generally viewed as a device for minimizing the social cost of private activities, and for forcing actors to internalize the full cost of their actions. An efficient liability system causes actors to consider the full cost of their actions. Limiting liability can thus be seen as subsidizing risky behavior and allowing some actors to externalize part of the costs of their actions[69].

Beyond incentivizing investors to invest without the fear of loss of their personal assets and also promoting economic efficiency by enabling the investors take less risk and make more money[70] owing to their firm's liability by narrowing the extent of liability to be imposed on them, the concept of limited liability makes a number of other traits of the corporation feasible[71]. For example the transferability of shares would be severely hampered in the absence of limited liability. Every potential buyer of shares in a company would have to investigate the wealth of all other shareholders in order to determine the exact risk he faces in becoming a shareholder[72]. Insecurity concerning the risk carried by an investment directly results in complications in the valuation of shares. Limited liability, consequently, enables the existence of stock markets since a single share price can be listed for investors to observe. Under unlimited liability share prices would fluctuate not only due to the operations of the company which affect the present value of future cash flows, but also due to changes in the personal wealth of all shareholders[73].Thus, the

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[67] Lo Pucki, Lynn M (1996), '*The Death of Liability? Systems/Strategic Analysis'*, 106 Y. L. J., 1, 20 (1996)
[68] Id
[69] Supra note 59, at 6. David states that, two reasons are generally advanced for limited liability. First, it promotes economic efficiency; second, it allows access by people of lesser means to risk taking and money making
[70] Supra note 66, at 390
[71] Supra note 33, at 7
[72] Id
[73] Easterbrook and Fischel, *The Economic Structure of Corporate Law*. p. 42-43(1996), See also Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DePaul Bus and Com. L. J. 51, 54 (2004) supra note 13-21 In their book, Easterbrook and Fischel, listed six advantages that limited liability can offer, in support of their theory. Those are: "(1*) Limited liability reduces the entity's and its*

simplification of transferability of shares, by the presence of limited liability, serves as a check and balance against the power of the management of the firm.

What is more, it is also argued that in the absence of limited liability it would, even, be impossible to define the amount of specific risk of a portfolio through diversification since every investment could claim not only invested capital but also personal wealth. Thus, now a day the concept of limited liability is being contended as a ***sine qua non*** for an efficient and vibrant trading environment[74].

2.4.3. The Drawbacks of Limited Liability and Its Mitigation

2.4.3.1. Drawbacks of Limited Liability

As it bestows up on the corporate shareholders the above so discussed advantages, limited liability is not also without a disadvantage seen in light of creditors of the business firm. Thus, limited liability among others can cause a risk of moral hazard[75], which the managers of the firm may engage in over-risky endeavors knowing that the burden of the risk will fall up on other's shoulder[76]. On this point, what is more costly is that the party to whom the risk is transferred

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shareholders' need to monitor its agents, which makes passive investing and diversification a more rational strategy, reducing the costs of operating the entity. (2) Limited liability reduces the need to monitor other shareholders to see whether they can properly bear the risks that the entity plans or is undertaking. (3) Limited liability promotes the free transfer of shares, which creates incentives for managers to act efficiently since the results of their inefficient actions will be punished by the market. (4) Limited liability makes shares homogenous commodities that reflect all the information publicly available about the entity. In a situation of unlimited liability, not all shareholders would be able to access relevant risk information, and would thus value the share price differently. (5) Limited liability allows for more efficient diversification of one's assets. In a regime of unlimited liability, the rational strategy would be to minimize one's holdings since any one holding could explode and force one into bankruptcy. Diversification is desirable since it is a much safer strategy and will induce investors to put more capital into the markets; investors will be able to balance better their risks. (6) Limited liability prevents managers from becoming unduly risk averse."

[74] Supra note 33 at 8

[75] Henry Hansmann & Reinier Kraakman,"*Toward Unlimited Shareholder Liability for Corporate Torts*", *100 Y.L.J.*, 1879, 1883 (1991). They states that limited liability encourages overinvestment in hazardous industries since it permit cost externalization. The managers would do so to make the investment attractive, but at the cost of others

[76] Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DePaul Buss. & Comm. L. J., 55, 55 (2004) "… much of the criticisms on limited liability focuses on the concern that the liability protection creates a greater incentive for managers of firms to engage in risky behavior" See also Supra note 59, at 7. See also Halpern, et al, *An Economic Analysis of Limited Liability in Corporation Law,* 30 U. TORONTO L.J. 117, 148 (1980). These authors claimed that and objected limited liability rule as unfair to creditors and an invitation to reckless behavior by those doing business in a limited liability firms. They added that, 'in the case of small, tightly held companies, a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors'.

may be less well prepared to bear it than are the shareholders, especially in the case of creditors who are other than traded firms such as employees and customer[77].

On top of incentivizing managers to invest toward a risk industries, the presence of limited liability will also make the shareholders not to or buy an insufficient insurance to cover the losses that their firm's might incur[78]. On the contrary, it is argued that firms would most likely buy more insurance under unlimited liability in order to cover foreseeable[79].

2.4.3.2. Ways of Mitigating the Drawbacks of Limited Liability

It is quite clear that limited liability rule is there in business organizations as a wall between the owners of the business organizations and its creditors. Thus it has to be made clear as to whether this wall could, sometimes, be moved in order to keep the balance between these two separate parties, owners of the business firm and its creditors. Besides, as it has been stated above, limited liability has a number of disadvantages, especially, to the firm's creditors. Thus, it is important to look for how states have tried to control or at least minimize the drawbacks of limited liability.

2.4.3.2.1. Piercing Corporate Veil

Cognizant of the cost that limited liability rule is making creditors pay; states adopted a mechanism of disregarding the protection of limited liability wall. Thus, on this issue, in the US, one of the prominent common law country, it is accepted and recognized that under particular circumstances the rule of limited liability will and has to be abolished in order to advance interest of the corporation's creditors[80]. Thus, the process to be used in order to abolish the application of the rule of limited liability for creditors is commonly termed as piercing or lifting the veil or disregarding the entity[81]. In the German's corporate law as well, which is one among the leading civil law states, there is similar rule and understanding that the general limited liability rule needs to be disregarded regarding obligations of an *Aktiengesellschaft,* stock corporation, and a

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[77] Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 J. Inst. & Theo. Eco, 601, 606 (1985) available at: http://www.jstor.com/stable/40750809

[78] Supra note 75, at 1889, These (Hansman and Krakman) authors stated that most firms choose to buy a low coverage limit liability insurance

[79] Timo H. Kaisanlahti, 'Extended Liability of Shareholders', 6 J. Corp. L. Stu. 139, 144 (2006)

[80] Carsten Alting, Piercing the Corporate Veil in American and German Law - Liability of Individuals and Entities: A Comparative View, 2 TJCIL, 187, 190 (1995

[81] Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 Col. L. Rev. 496, 497 (1912) Professor Wormser was the first to use the term., cited on Carsten Alting, above, note 6 I

Gesellschaft mit beschraenkterHaftung (GmbH), which is similar to a limited liability company[82].'

Thus, it is quite understandable from the reading of the above paragraph that there is a common understanding both among the civil and common law legal families, that limited liability rule is not absolute and needs to be disregarded, most importantly, to safeguard the interests of the company's creditors. Once it is determined that limited liability rule can and has to be limited, the next move would be in distinguishing the circumstances by which the limited liability rule of shareholders of a company and partners or members in partnerships firms could be limited. In relation to this point, both the common law and the civil law states have their own ground to do so.

Both under the US and Germany's law, limited liability wall would be disregarded when a situation that involves domination of the company[83], undercapitalization of the company[84], commingling of shareholders and the company's assets and a disregard of corporate formalities has happened[85].

2.4.3.2.2. Adopting Mandatory Insurance Scheme

In addition to the rule of piercing corporate veil, it is believed that there has to be some other sort of solution in order to advance the interest of those creditors whose interests are affected by the operation of limited liability rule. This could mainly be because the procedure of piercing corporate veil could be a lengthy process which also affects the creditors own pocket and even after they successfully able to pierce the corporate veil, it may be possible that they may be unable to collect their sum of money back, fully. Thus, as a compliment to, or as an option of avoiding the procedure of piercing corporate veil it is suggested that, there has to be another

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[82] Id

[83] Supra note 80, at 200. As far as domination is concerned, it is argued that 'an individual's mere domination of an entity does not justify disregarding limited liability obtained under corporate law.' This is also true with respect to one-shareholder corporations, which are not regarded as being against public policy. Therefore, piercing the veil occurs only if additional factors, such as fraud, inequity and the like are shown

[84] Id, from p. 201-210., Although in the US, the minimum legal capital is not set and it is statutorily provided under German law, there is similarity in that both states from the two legal families recognized under capitalization that may happen either at initial or later stage of the operation of the company as one ground of disregarding the wall of limited liability and make shareholders also liable towards creditors of the firm.

[85] Id at 92

solution. That is not only to extend liability to shareholders, but to make the firm either have a larger capitalization, or purchase insurance on behalf of these creditors[86].

2.5. THEORETICAL BASIS OF LIMITED LIABILITY

It is contended, mainly that the need and justification for limited liability is realized in the economic benefits it offers. As observed by Sheahan. J[87] limited liability helps in decreasing the costs to shareholders of monitoring the actions of managers, increases the incentive to act efficiently by promoting the free transfer of shares. It also increases the efficiency of securities markets since share trading does not depend on an evaluation of the wealth of individual shareholders, but of the firm itself. Limited liability also create incentives for excessive risk taking by permitting firm owners to avoid the full costs of their business activities while reaping the full economic reward of such activities[88]. It was also added that, limited liability encourages shareholders to hold diverse share portfolios and thereby permitting companies to raise capital at lower costs because of the shareholders reduced risks and the facilitation of optimal investment decisions by managers.

Moreover, according to scholars, there are at least three potential theoretical bases for limited liability protection that worth discussion[89]. Thus, these three theories or approaches are a Utilitarian cost benefit approach, the nexus of contracts conception of corporation (the contractarian theory) and the democratic theory.

2.5.1. A Utilitarian Cost-Benefit Approach (Economic Theory)

According to a utilitarian cost benefit approach, limited liability protection frequently is assumed to reduce transaction costs and enhance efficient operation of the securities markets, and therefore is considered an acceptable social cost of securing efficient capital financing[90]. However, this utilitarian cost benefit approach is not supported with a literature that will answer

[86] Supra note 77, at 1889
[87] Sheahan. J, Concept of Limited Liability cited on Irshad Hameed, The Doctrine of Limited Liability and the Piercing of the Corporate Veil in the light of fraud: A critical multi-jurisdictional study, p. 5-6
[88] J. William Callison, Rationalizing Limited Liability and Veil Piercing, the Business Lawyer, 58, No. 3, 1063, 1063 (May 2003), available at: https://www.jstor.org/stable/40688148
[89] Id at Id, at 1064-1066
[90] Supra note 8, at 83-86

whether benefits outweigh costs with respect to closely held firms or vice-versa[91]. On top of this, it is also said that even if a utilitarian approach is appropriate, it is arguable that limited liability protection should be extended only to those firms that require third-party equity financing and, therefore, that the owners of closely held entities should have personal liability to some extent[92].

2.5.2. Nexus-of-contracts conception of corporation

Limited liability can be regarded as a term of the contract among shareholders and a creditor which is wealth-maximizing for both creditors and owner's[93].It is even argued that, legal rules providing for limited liability, far from conferring a privilege, are irrelevant because the parties can contract for limited liability[94]. Under this conception, the importance of corporate personhood is reduced and the corporation becomes a bundle of market-driven actual and hypothetical bargains among shareholders, managers, and other firm participants, including outside third parties that deal with the firm[95]. By the same token, neither corporations nor their shareholders are thought of as having external moral or social obligations independent of contract the corporation because it is not a person and the shareholders because they do not contract for broader responsibilities[96]. However, under this approach as well, to the extent the firm's activities cause third party liabilities; it is possible that liability allocated to the firm members[97].

2.5.3. Democratic Theory

One among the major objectives that limited liability was conceived is to achieve democratization of wealth or the opportunity to accumulate it[98]. A theoretical basis given to limited liability protection under this view is that, by allowing investors of moderate means to

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[91] William W. Bratton & Joseph A. McCahery, *An Inquiry Into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition*, 54 Wash. & Lee L. Rev. 629, 631 (1997), (concluding that economics literature fails to support a presumption favoring limited liability)., See also supra note 75, at 1879.
[92] Supra note 88, at 1064
[93] Supra note 38, at 82
[94] Meiners et al, *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351, 364 (1979).
[95] Supra note 88, at 1066
[96] Id
[97] Id
[98] Lllewellyn L. Llanillo, *Limited Liability Companies: Emerging Trends In Veil Piercing*, 81 Philip. L. J. 669 (1961)

invest in business firms, limited liability protection keeps entry into business markets competitive and democratic and, thereby, allows economic progress[99].

Thus, as it can be understood from the above discussed various theories, limited liability is among others justified, firstly, by the fact that it encourages economic expansion through investment by incentivizing investors through aversion and minimization of risks that might materialize in the business (economic theory), secondly because the firm owners may limit and externalize a liability of their firm not to be extended to their personal assets through a contract (contract theory) and thirdly because it will make an entry in to and operation in a business competitive and democratic.

2.6. CONCEPTAUAL OVERVIEW OF UNLIMITED LIABILITY

2.6.1. Natures of Unlimited Liability

Owners of business organizations may either because of the nature of their firm, mostly as in the case of partnerships, as a rule, or exceptionally, as in the case of companies, may be subjected to unlimited liability[100]. Thus, be it as a rule or as an exception, the owners of the business firms are subject to unlimited liability means that, the share or stock holders in companies or the partners in case of partnership business firms will be subjected to liability not only to the extent of their pre-contribution to the firm that has become cause for the liability, but also from their universal personal asset[101].

2.6.1.1. Unlimited Liability as a Rule

As have been discussed above, the rule of limited liability lies on the basic principle of 'separate legal personality of the firm from its owners' and the principle of 'separation of management and ownership[102].' Hence, in those firms in which the legal personality of the owners is not separate from that of its owners and where the management and ownership of the business is the same, then, liability would be unlimited. This is mainly because, as can be inferred from the justification given to the rule of limited liability, first, the business firm does not have a personality separate from its owners and secondly because, the owners are the managers (no

[99] Supra note 88, at 1066
[100] Because, in companies, limited liability is one among the five characterizing core features. See for instance, see supra note 11
[101] Supra note 8, contrary reading
[102] Supra note 11 see also supra note 33

separation of ownership and management) and hence they could have avoided the liability that has raised. For instance, during the era of *commenda*, as is currently the case of limited partnership, the partner who invest his capital but does not participate in the management is liable only to the extent of his contribution and the partner who was managing the partnership firm is liable both from his share in the firm and his personal assets[103].

2.6.1.2. Unlimited Liability as an Exception

Since the fact that firm owners enjoy limited liability while they collect fruits of their business to its best possible full extent, as scholars argue, "the benefits of limited liability may exceed its costs.[104]" Thus, it is claimed that limited liability is not absolute[105] or it has never been absolutely limited[106] and a close and continuing scrutiny of limited liability is needed to assure that its protection to the firm owners does not extend further than necessary to achieve the societal purposes for such protection[107]. Accordingly, when the Company functions as a tool for fraudulent purposes or is engaged in fraud[108], as one example, it is possible that the firm's immunity be counter measured by piercing the corporate veil[109] so created by its incorporation. The concept of corporate veil is expressed as "a metaphorical reference to the limited liability of a corporation, based on the prevailing rule that when corporate formalities are observed, initial financing is adequate, and the corporation is not formed to defraud creditors or other third parties, the corporate form will be respected and shareholders will not be liable for corporate debts and liabilities[110]"

Furthermore, limited liability can be restricted and unlimited liability could become a rule exceptionally when the corporate veil so granted by limited liability is used by the business

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[103] Supra note 41, at 615 R.W. Hillman, "Limited liability from a historical perspective, "the commenda was a vehicle that allowed a passive member to invest funds without risk of incurring further liability (other than the capital contributed). The managing partner's liability was regarded as unlimited."
[104] Supra note 36, at 23
[105] Id, at 7
[106] Supra note 3 at 89
[107] Supra note 88, at 1063
[108] Supra note 33, at 14
[109] Id, at 9
[110] Karin Schwindt, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1550 (1997)

entity as a vehicle to defeat public convenience, justify wrong and to protect fraud or defend crime[111].

2.6.2. Sources of Unlimited Liability

Unlimited liability in a business firms may, at least, arise in three different ways. Thus, firstly, from the nature of the firm itself, secondly as an exception when limited liability is the rule by and thirdly, through contractual terms[112].

The *first* possible source of unlimited liability of owners in business firms is attributed the way form in which the firm is formed. Thus, especially, when the firm is established in the form of partnership, then the partners are subject to unlimited liability[113].

The *second* source of unlimited liability of owners of a business firm is when, by the operation of the law, a corporate veil is pierced. Thus, when the firm is a limited liability business organization, then in such scenarios, a theoretical cause for unlimited liability would be the fact that such firm has engaged in a fraudulent activity or other morally hazard behavior which can make the limited liability wall be pierced and disregarded[114].

The *third* arguable source of unlimited liability is contract[115]. Like limited liability itself, unlimited liability may also raise form a contract between the firm's owners and third parties or creditors. Thus, partners in limited liability partnerships or limited partners in a limited partnership as well as a shareholder in a limited liability companies may enter in to a contract with the firm or third party that their liability, if any be unlimited one.

2.6.3. Advantages of Unlimited Liability

The advantage aspects of the unlimited liability rule can best be described under the public interest approach, as it is called by some writers[116]. Thus, according to the public interest

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[111] Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1158 (1994) cited in Jeffrey K. Vandervoort.

[112] The thing is that, after going through various literatures, the writer comes with these three possible sources of unlimited liability in business firms.

[113] In most cases, especially in the case of limited partner in in limited partnership and partners in general partnership, liability of the partners is unlimited.

[114] Here, unlimited liability comes as an exception to the operation of limited liability rule. See Eric Fox, Piercing the Veil of Limited Liability Companies, 62 GEO. WASH. L. REV. 1143, 1158 (1994) and also Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DePaul Business and Commercial Law Journal 53 (2004).

[115] This is by allowing contractual right of the owners. Such scenario may arise after being established as a limited liability firm, a wise creditor approaches the firm and negotiates to keep his best interest intact by demanding them to agree to avoid limited liability.

[116] Jack L. Carry and G. Frank Mathewson, *Unlimited Liability as a Barrier to Entry*, 96 J. Pol. Eco. 766, 768 (1988)

approach, especially in the past, why the states use to impose unlimited liability, on a selective basis, lies on the fact that unlimited liability protects uninformed or inadequately informed customers a and serves as a safeguard in case of potential risks. This is so, based on the market failure argument states that there may be market failure and thus, unlimited liability provides protection to the uninformed consumer[117].

In the second place, the argument in support of unlimited liability presented is that, those running business entities remain under unlimited liability will help in protecting uninformed creditors. Thus, it will discourage the managers and the owners of the business from engaging in a moral hazardous behavior[118]. This is because; the managers and owners of the entity may exploit their creditors knowing that they will be protected by the wall of unlimited liability[119]. Thus, in order to make these managers and owners not to exploit the creditors of the entity by entering in to risky transaction, unlimited liability is necessary to tackle them.

In the third place, seen sector specific, unlimited liability rule can build confidence in depositors, eliminate system wide runs and can preserve stability of the bank[120]. Suppose in the absence of unlimited liability that there is mismanagement within the bank it will diminish depositor's confidence which can led to bank runs[121] and the system's instability.

2.6.4. Drawbacks of Unlimited Liability

Since limited liability is introduced in the law of corporation in order to avoid the problems related with the existence of unlimited liability, unlimited liability negates the advantages of limited liability. Thus, the costs of unlimited liability can be deduced from what Frank H.

[117] Id, at 769

[118] It is because, when the firm is a limited liability frim and the managers and the owners are entitled to limited liability, since they know that risk can be shouldered by another, creditors, they will engage in a risk endeavors. However, unlimited liability is can make this undone. See also Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DePaul Business and Commercial Law Journal 55 (2004) above

[119] Supra note 116

[120] Id

[121] Supra note 4, Black law Dictionary 8nd Ed. Bank run is 'a sudden withdrawal of depositors who no longer trust their bank or economy.' See also Will Kenton who describes the concept saying that, 'a bank run occurs when a large number of customers of a bank or other financial institution withdraw their deposits simultaneously over concerns of the bank's solvency. Available at: https://www.investopedia.com/terms/b/bankrun.asp.

Easterbrook and Daniel R. Fischel stated and listed in support of their argument towards the role of limited liability[122].

Accordingly, unlimited liability, *first*, discourages investors not to confidently invest in a capital intensive business. Because, absenting limited liability investors may lose interest in investing[123]. *Secondly*, the existence of unlimited liability in certain form of business will hamper economic efficiency because if liability is not limited, investors cannot make money while assuming more risk. *Thirdly*, in the presence of unlimited liability, there will not be free transfer of shares[124]. This is so because, when liability is unlimited, claimants will target the investors with a greater wealth, than the others[125]. Thus, in order to shift liability, the owners will not be interested in accepting an investor with less wealth than they have, thus restricting a free transfer of shares[126].

Fourthly, in the presence of unlimited liability, there may not be an efficient diversification of assets. This is because in a regime of unlimited liability, the rational strategy would be minimizing one's holdings since the liability in there may result in bankruptcy[127]. In the *fifth* place, unlimited liability makes it highly necessary for the owners to monitor their managers and agents because; if they failed the monitoring and then, the managers engaged in risky undertakings they will be forced to bear the liability[128].

Besides, unlimited liability can also, sometimes, become a barrier in investors' choice of liability rules[129]. Thus, for instance, in professional services such as accounting, law and medicine, owners of firms were used to be forced to accept unlimited liability[130].

2.6.5. Unlimited Liability: Liability Imposed on Whom?

The essence of limited liability is that it denotes the shareholder in company and partners in some forms of partnership firms are not liable for the debt and liability of the company or the

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[122] Supra note 73, at 42-43
[123] Id
[124] Id
[125] Supra note 79, 143
[126] Id
[127] Id
[128] Id
[129] Id
[130] Id

partnerships more than what they have already invested in the firm[131]. Thus, this is to mean that, if a liability arises in such cases when the shareholders and the partners are benefiting from limited liability, creditors can claim payment only from the assets of the company or the partnership.

However, when liability is unlimited either owing to the nature of the firm itself or due to the acts of the managers of such firm, it must be answered that who is liable; shareholders or partners, the managers, or the firm itself.
Being the main beneficiary of limited liability, owners of a firm, shareholders and partners are at the center of the concept limited liability rule. Thus, when liability become unlimited either do to the operation of the law, contractual terms or when corporate veil is pierced owing to some factors attributed to the act of the firms managers or shareholders, and the asset of the company is not sufficient to cover the claim of creditors, then, the first group of people to assume liability would be the shareholders and partners in the firm[132].

The *second* group of individuals on whom liability may be imposed up on is the members of the board of directors. Director, although not subjected to a strict liability, are liable to the company and the creditors for culpable violation of their statutory or contractual duties[133]. For instance, under German law, directors are jointly and severally liable internally, towards the company, for damages caused if they fail to apply the care of a prudent and diligent manager[134]. Equally speaking, directors are also externally liable towards third parties for breach of laws during their management[135]. Under the France commercial code as well, directors are liable among others for failing to declare insolvency of the company within the legal terms and are also liable when there is a deficiency of assets to pay off liabilities during liquidation and it is proved that management has contributed to the deficiency[136].

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[131] Supra note 77, at 60. Susan states that creditors of limited liability firms acknowledge that debts will be paid only from the assets of the firm itself and that the shareholders are not personally liable for more than they have invested in the firm.
[132] This rule is virtually accepted almost in all jurisdictions having business entities with limited liability. See Guide to Going Global Corporate, a Full Handbook, Prepared by DLA Piper, 2020, available at: https://www.dlapiperintelligence.com/goingglobal/ accessed on 18th of Nov, 2020.
[133] Karin Madison, *Duties and Liabilities of Company Directors under German and Estonian Law: A Comparative Analysis*, RGSL Research Paper, 13 (2020)
[134] Id, at 14
[135] Id, at 15
[136] French Commercial Code arts 225-248 & art L 651-2 of the code. See also Olivier Sanviti, *Directors Liability in Corporate Law: Cross Jurisdictional Comparative Discussion*, Available at:

2.6.6. Forms of Imposition of Unlimited Liability

The liability to be imposed on shareholders or partners of a business firm in case they are subject to unlimited liability can be arranged in two distinct forms[137]. These are joint *and several liability* and *pro rata liability.* When liability is imposed in the form of joint and several one, then, each of the shareholders are liable to the full amount of the claim to the extent that it exceeds asset of the firm[138]. Thus, the creditor of the firm can claim the total amount in excess of the firm's asset from a single individual, if he needs, and each shareholder subject to joint and several liability would be liable pay share of their co-shareholders. The joint and several rule of liability are prevalent in partnerships than in case of corporations since in the latter case it applies only when corporate veil is pierced[139].

The other form of imposition of unlimited liability is in the form of *pro rata* rule which is known as a *proportionate liability rule*[140]. Under the pro rata liability rule, each of the shareholders is personally liable to cover the payment of liability on excess of the firm's asset only to the extent of their shares in the firm[141]. Thus, unlike a joint and several liability rules, in a pro rata liability rule, a shareholder is not obliged to cover the liability share of his fellow shareholders.

2.7. BUSINESS ORGANIZATIONS UNDER ETHIOPIAN LAW: A BRIEF OVERVIEW IN LIGHT OF LIABILITY

This subtopic of the chapter, with a view to provide a background to the analysis to be made in the later part of this study, is devoted to provision of brief description of the Business organizations under Ethiopian laws in light of their liability. In particular, this sub topic introduces the laws governing and the types of business organization in Ethiopia and then discusses their liabilities.

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https://www.ipgonline.org/news/item/33/#:~:text=French%20law%20prohibits%20any%20limitation,this%20action%2C%20will 20be%20ineffective accessed on 17th Nov. 2020).

[137] Supra note 79 at 145. See also supra note 75, at 1891

[138] Id

[139] Id, at 1893

[140] Joseph A. Grundfes, *The Limited Future of Unlimited Liability*: A Capital Markets Perspective, 102 Y. L. J. 387, 388 (1992).

[141] Supra note 75

2.7.1. Introduction to the Law of Business Organizations in Ethiopia

The major part of the laws governing Business Organizations in Ethiopia are found under Book II of the 1960 Ethiopian Commercial Code[142]. Book II of the commercial code is devoted to govern the formation, operation, expansion and winding up of six types of Business Organizations[143]. In addition to these modes of business recognized by the commercial code, the draft code has introduced two additional types of BOs, Limited Liability Partnerships and Private Limited One Man Company[144]. Each of these forms of business organizations are briefly explained below with a focus on liability. Although the commercial code is a substantive law providing a substantial part for the formation, operation and dissolution of BOs in Ethiopia, there are also other laws which are indispensable for the formation and effective operation of the BOs. These laws are; Ethiopian Civil Code of 1960, Investment Proclamation 1180/2020, Investment Regulation No. 474/2020 , Public Enterprises Proclamation of 1992, Cooperative Societies Proclamation No. 985/2016, Trade Competition and Consumer Proclamation No. 813/2013, the Commercial Registration and Business Licensing Proclamation No.980/2016, and the Commercial Registration and Business Licensing Regulation of 2016.

2.7.2. Business Organizations under Ethiopian Law Vis-à-vis Liability

2.7.2.1. Liability of Partners and the Partnership Firms under Ethiopian Law

A partnership is defined by the Black's Law Dictionary, as "a voluntary association of two more persons who jointly own and carry on business for profit[145]. The Commercial Code of Ethiopia recognized four types of partnerships as a mode of business[146]; however, without explicitly defining it. However, by looking at the definition given to partnership agreement and Business Organizations by the code[147] one can define and understand partnership as a business organization by which two or more persons come together through an express contract to engage in certain economic activities by joining their contributions in the form of money cash, skill,

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[142] Id, art 210-560

[143] See art. 212 (1) of the code which has listed six types of business organizations; Ordinary Partnership, General Partnership, Limited Partnership, Joint Venture Share Company and Private Limited Company

[144] Supra note 23, the draft commercial code of Ethiopia, 2020, arts. 257-270& arts. 505-538.

[145] Bryan A. Garner, Black's Law Dictionary, 8th ed ,West Publishing Co. St. Paul, 2004, P. 3544. See also the US Uniform Partnership Act Section 6/1., which defines partnership as 'an association of two or more persons to carry on as co-owners a business for profit.'

[146] Supra note 19, art. 211

[147] Art. 211 of the commercial code defines PA as 'a contract where by two or more persons who intend to join together and to cooperate undertake to bring together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out there of, if any.'

labor and or service and thus, to share from the profits to be made and a loss that could arise in the business.

Members of a partnership firm are liable to pay third party from their personal asset, in case the asset of the firm is found to be inadequate to cover claims of its creditors, because partnerships do not have legal personality of their own which is separate from their members[148]. Thus the principle is that in partnership firms liability is unlimited. The exceptions in this regard are; a limited partner in limited partnership[149] and partners under the upcoming limited liability partnership, in which case liability of the members is limited to the asset of the firm itself alone[150]. However, in the case of limited liability partnership as well, liability could be unlimited when partners fail to discharge their duty negligently or intentionally, and thus liability arises[151].

Managers in partnership are required by the law to act in the firm's name for the firm's benefit. Thus, managers are subject to a joint and several liabilities to the partners for failure to carry out their duties[152]. However, if a manager, disregarding, such obligations and acts for his own benefit and deals with third party using his own name (except in case of joint venture), such manager shall alone be liable[153]. In addition, when managers acted beyond the scope of power given to them[154] and deals with the partnerships for themselves with a prior approval of the partners[155], such managers shall be liable alone.

In partnership, there is a possibility by which a non-member may become liable jointly and severally together with the members towards third party. Thus, that is, when that person allows his name to be included and used in the partnership firm's name[156]. Likewise, a limited partner in limited partnership who allows his/her name to be used in the firm's name and or acted as a manager is jointly and severally liable to a third party in good faith[157].

[148] Id, See arts, 280/1, 296
[149] Id, art 296
[150] The draft commercial code, art 257/1 of the draft code
[151] Id, art 265/2
[152] Supra note 19, commercial code art. 241/2
[153] Id, arts 290/1&2
[154] Id, art 290/3
[155] Id, art 291
[156] Id, art 281/3
[157] Id, art 297/2/3 & 301/3

An indispensable point in discussing liability in partnership firms is that, the partnership firm itself can be held liable towards third party. Thus one such scenario is when the manager of a partnership firm acted with third party in good faith using the firm's name but for his own profit[158]. The partnership firm is yet liable even if the manager used his own name but the third party in good faith shows that he was transacting on behalf of the firm[159].

2.7.2.2. Liability of Companies and Shareholders under Ethiopian Law

Although it is true that shareholders of a company enjoy limited liability as a result of the company's separate legal personality[160], founders, shareholders, managers or directors and also auditors could be held liable. Thus liabilities of these groups of individuals can arise either during the formation, operation or dissolution of the company.

Founders are the *first* group of individuals to be made liable in companies. During the formation of a Share Company founders[161] shall be liable to third party in respect of commitment entered for the formation of the company[162]. However, later, after formation of the company, the firm will take over such liability of the founder and compensate the founder when it is found that expenses and commitments made were in fact necessary for the formation of the company.

The liability of founders could be towards the company, third parties and subscribers. Founders are liable to the company for a wrong related with subscription of the capital and the payment required for the formation of the company[163]. This refers, for instance, to a liability of founders in case of formation of the company without its capital being not fully subscribed or for a wrong in valuation of contribution in kind. In the second place, founders are also liable towards third party for inaccuracy of statement they made public in relation to formation of the company[164]. Thirdly, founders are liable to repay subscribers of share, in case registration of the intended company has not been made within one year[165].

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[158] Id, art 290/1, 303
[159] Id
[160] Id, arts 304/1, 510/1& 210/2
[161] As defined by Art. 307 of the commercial code founders are persons who sign the MoA and subscribe the whole capital, persons who sign a prospectus, bring contribution in kind or to be allocated a special share, or any other person who has initiated the plan or facilitated the formation of the company
[162] Id, art 308/1
[163] Id
[164] Id, art 308/3
[165] Id, art 312/3

In relation to liability of founders, there is a limitation of period within which a claim has to be brought. Thus, the code states that the claimant need to bring his claim within five years starting from the date when he came to knew of the damage and of the person liable[166]. What is more, a claim against founders is absolutely barred after ten years since the act took place[167], save for when such liability arises from criminal, in which case there will be no limitation[168].

The *second* groups of persons to be held liable in companies are shareholders. In a share company, the legal minimum number of members is five and if there is a reduction of members below the legal minimum and the remaining members contracted any debt after such reduction, then they will personally be liable for such debts[169]. Similarly, members of a PLC are also jointly and severally liable towards third party for over or undervaluation of a contribution made in kind[170].

A shareholder who has pledged his share and there comes a call of liability relating such pledged share, the shareholder shall answer to it[171]. In such cases, if the shareholders are more than one, then they shall be made liable jointly and severally[172]. In a similar fashion, holders, previous assignee's and subscribes are made to be jointly and severally liable for calls on such shares, thus, within a period of two years[173].

Similarly, shareholders in a PLC are subject to a jointly and several liability towards third party a mistake in valuation of a contribution made in kind[174]. The members are liable both for and over valuation and undervaluation. Besides, in time of bankruptcy, shareholders of a PLC who has acted as a manager can be held liable for the debt of the firms' creditors when the asset of the company is found to be inadequate[175].The shareholders liability in such scenario is not

[166] Id, art 309/2
[167] Id
[168] Id, art 309/3
[169] Id, art 311/1
[170] Id, art 519/3
[171] Id, art 329/2&3
[172] Id, art 328/4
[173] Id art 342/1
[174] Id, art 519/3
[175] Id, art 531/2

automatic, because there has to be a bankruptcy declaration as per the provisions of the code. They can escape liability if they can show that they have acted in due care and due diligence[176].

In the *third* place, directors of a company can be held liable for their act or failure to act towards the company's creditors, the shareholders and the company itself. Accordingly, first, director is liable toward creditors for damages that may arise from fraud during his dealing with third parties without the board approving such dealings[177]. In such cases, when the director fails to meet his liability, then the members of board of directors shall be liable to cover the damage[178]. In the second place, directors shall be liable to creditors of the company for failing to keep the company's asset intact[179] and when the company's assets are insufficient to meet such liabilities[180].

A company's directors are jointly and severally liable towards the company for failing to act with due care and take all steps within their power to prevent or mitigate acts prejudicial to the company which are within their knowledge and damage is caused[181]. However, for an action to be instituted to make the directors answerable for such damages there has to be a resolution of a general meeting to this effect[182].

Finally, directors are also liable towards the shareholders of the company and third parties for a damage caused to them due to their fault or fraud[183]. In such cases, unlike as in the case of making directors liable to the company, there is no need to have a resolution of the general meetings[184]. Similarly, managers of a PLC and a nominee in case of a PLOMC are also held liable towards the company and third parties, individually or jointly and severally, for a damage caused by their breach of duties[185].

The other groups of persons, who can be tied with the web of liability of companies, are auditors. Thus, auditors of a share company are liable to the company and third parties for a loss caused

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[176] Id, art Id, 531/2
[177] Id, art 356/5
[178] Id
[179] Id
[180] Id, art 366/2
[181] Id, art 364/2&4
[182] Id, art 365/1
[183] Id, art 367
[184] Id, art 367, states that nothing in this section shall affect the rights if shareholders and third parties…'
[185] Id art 530 of the code and art 526/3&4 of the draft code

by their fault in the exercise of their duties[186]. In a PLC if the members are more than 20 the PLC will have an auditor[187], and if these auditors cause damage to the company or third party, it is possible to analogize the liability of auditors in the case of Share Company[188].

[186] Id, art 380/1
[187] Id, art 525/2
[188] Id, art 380/1

CHAPTER THREE

3. ANALYSIS OF THE MAJOR LEGAL PROBLEMS ASSOCIATED WITH LIMITED AND UNLIMITED LIABILITY UNDER ETHIOPIAN LAWS

3.1. INTRODUCTION

Being the main chapter of the thesis, this chapter deals with the discussion on the analysis of the major legal gaps associated with limited and unlimited liability under Ethiopian laws. The discussion made under this chapter is build up on the discussions so made under the second chapter of the thesis. Accordingly, under this chapter, the researcher has demonstrated and shows the major legal problems associated with the concept of limited and unlimited liability under Ethiopian laws under the following sections.

3.2. LIMITED LIABILITY VIS-À-VIS PERIOD OF LIMITATION

Under a topic dealing with liability, it is of a paramount importance to also discuss as to the time within which the liable person is required to pay and the time within which the creditor claim his right. This period of time within which a party must bring claim is referred to as period of limitation. Putting a period of limitation in a given legal prescription helps in bringing certainty and finality in litigations as also to avoid litigation over delayed matters because in such cases there could not be fair trial[189].

Under the commercial code, in relation to liability, there are a couple of provisions dealing with limitation of period. The *first* one is in relation to liability of founder of a company[190]. The code states that when there is a damage caused by a founder of a company and the claimant demands action, he should make it so within a period of five years from the date when he came to knew of the damage and of the person liable[191]. For what so ever reason, a claim against founders will absolutely be barred after ten years since the act causing the damage took place[192]. The liability discussed under the provision of the code is a liability that founders owe towards the company

[189] Nigel Adams, Limitation Periods: What they are, why they matter and how to avoid their unpleasant Consequences, Goodman Derrick LLP, 2019, https://www.gdlaw.co.uk/site/blog/our-services/dispute-resolution/limitation-periods-litigation last accessed on 15th Jan, 2021
[190] Supra note 19, commercial code art 309/2
[191] Id, art 309/2
[192] Id

and third parties. It is possible to say that, thus, the company and any third party who claims compensation from the founders should bring their case before court within five years after knowing the occurrence of the damage and the person to be responsible for it. Thus, the cause for such claim can be a fraud or mistake in relation to subscription and payment of capital for the formation of the company, valuation of contribution in kind[193] and inaccuracy of public statements regarding formation of the company[194].

The *second* limitation period specified in relation to liability under the code is regarding the liability of holders, pervious assignees and subscribers[195]. Thus, a subscriber or shareholder who has assigned his share shall be liable regarding a liability attached to the shares within two years of his assignment[196].

Except for the above mentioned two separate periods of limitations, there is no such limitation provided by the code for liabilities in relation to directors, managers and auditors. Thus, the issues here is that whether the Civil Code provisions governing period of limitation are applicable in relation to liability of business organizations and their owners as well that of the people who manage such business organizations, if any, and on what grounds.

Accordingly, it is important to, first, look at the relationship between the two codes. From the reading of art.1 of the commercial code, it is quite clear that the civil code provisions be made applicable as a matter of principle, except where the commercial code states otherwise, to the status and activities of traders. Thus, one can argue that it is possible to use the period of limitations under the civil code. However, a counter argument that can be raised is that, if the Commercial Code lefts to provide limitation period to be governed by the civil code, why does it specify limitation periods in relation to liability of founders and assigned or transferred shares?

Thus, there is a problem of absence legal of regulation and inconsistency in the Commercial Code regarding a period of limitation within which creditors has to demand payment regarding liabilities of the firm, directors and that of managers. As far as concerned liability of founders and that of person who assigned share, the code provides for a period of limitation while it does

[193] Id, art 309/1/b & 315
[194] Id, art 309/1/c
[195] Id, art 342/1
[196] Id, art 342/2

not in relation to liability of the shareholders, partners, members of BoD and that of the firm itself.

3.3. HOLDING COMPANIES AND PARENT-SUBSIDIARY COMPANY VIS-À-VIS LIMITED LIABILITY

Holding company can be defined as a company who own assets of another company but does not engage in its operation having only a limited oversight role[197]. It is also defined as 'a company incorporating two or more limited liability companies and managed by the holder[198].' Thus, from the above definitions, holding companies buy or own assets of another company in order to gain more profit while incurring only a minimal risk. That is because, even when the subsidiary company whose asset is owned by the holding or parent company is declared bankrupt, the creditors of such subsidiary company cannot claim payment from the holding company. This is because, the parent and the subsidiary has a separate legal personality.

Thus, it is evident that such holding company or parent subsidiary arrangement will highly affect interest of the creditors of the subsidiary company. As a result, it is argued that while incorporation to protect the personal estates of passive individual investors has been accepted as efficient by many scholars, incorporating subsidiaries by the parent company in order to insulate its assets from the risk of particular activities, it is said to be inefficient. This is because; it allows corporations to externalize the costs of some risks[199].On this point, while emphasizing the negative effect of company holdings on creditors, one writer argues that 'limited liability was not designed to protect corporate shareholders; in the US, at least, corporate power to own shares in other corporations having limited liability[200].'

In Ethiopia the Holding Companies seems to have preceded a law governing them. That is because, while the Commercial Code is silent regarding formation and operation of Holding Companies, there were a number of de facto holding companies out in the market. Thus, for instance, the MIDROC Ethiopia Plc., DH Geda Group, Kadisco Group and the East African

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[197] Amy Fontinelle, https://www.investopedia.com/terms/h/holdingcompany.asp last accessed on 12th Jan, 2020

[198] Commercial Registration and Business Licensing Proclamation No 980/2016., Art, 2/40

[199] Blumberg, 1986, on William LL, p. 667

[200] Landers, Jonathan M '*A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*', 42 *Univ. of Ch. L, Rev,*, 589-652 (1975) on William J. Carney at 667

Holdings are to be mentioned[201]. It is five years back that the legislator comes up with a provision allowing establishment of Holding Companies. That is the Commercial Registration and Business licensing Proclamation No 980/2016, art 34, which seem is presumably made considering the pragmatic problem. The commercial code, although does not expressly provide for the rules governing holding companies it however, let a company having its parent company abroad operate by opening a subsidiary or branch in Ethiopia[202].Thus, the code and the proclamation are the legal frameworks governing Holding Companies and Parent-subsidiary arrangement of the firms.

Thus, with the understanding that company holdings which were in the practice are now becoming legally recognized, it is important to consider company holdings vis-à-vis liability. As it has been shown above, one mechanism, used by investors, to avoid or minimize liability, when engaging in business is to use a parent-subsidiary strategy. Thus, the owners of the firm in a parent subsidiary business will engage in a risky investment using the subsidiary while remaining safe under the umbrella of the parent company.

But the code, as some argued, will only make, and that too is by interpretation, liable the parent company from its asset by piercing the veil of the subsidiary if and only if the parent company has acted as a director in the subsidiary company[203]. However, the problem is that a wise parent company who knows the fact that its act as a director in the subsidiary company will result in such liability, will stay calm and ripe their profit.

When owners of a business operate by using the parent subsidiary strategy or company holdings, they will be entitled to a double standard liability protection. The first is that, the subsidiary company by itself is a limited liability company and hence its liability will not affect its owners, unless a corporate veil is pierced for a good cause. Secondly, the holding/parent company is also a limited liability entity which makes it untouchable by the creditors.

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[201] Mekonnen Teshome, *Holding Companies, The Needs Ethiopia to Mak*e, 17 Addis Fortune Megazine, Vol. 17 (2017), available at: https://addisfortune.net/columns/holding-companies-the-change-ethiopia-needs-to-make/) last accessed on 13th Jan, 2020

[202] Supra note 19, art. 556

[203] Id, art 347/4 cum 364 /6

3.3.1. Its Implication on Creditors and Shareholders

The problem regarding company holdings in their treatment regarding limited liability is that it could be very risky for creditors, both contractual and non-contractual, while it highly benefits the corporate shareholders. To let corporate shareholders, enjoy liability in an equal footing with that of physical shareholders, it would be unfair. Thus, first because they are corporate shareholders and not a physical person, they are in safe position to defend themselves and secondly, even if the creditors succeed and the corporate veil of the subsidiary is pierced, the creditors can only access capital of the parent company not the asset of the shareholders of the holding/parent company. This is because it is protected by another, separate legal personality, from that of the parent. Thus, to let corporate shareholders benefit from limited liability, without an equivalent restriction imposed to safeguard creditor's interest, will be problematic as it offers an extra protection for the corporate shareholders at the expense of creditors' interest.

3.4. THE MORAL HAZARDS OF LIMITED LIABILITY ON CREDITORS VIS-À-VIS THE REMEDIES AVAILABLE TO CREDITORS

The researcher under this sub topic answered that there is no adequate remedy source to which creditors may resort to, incase liability of the firm is unlimited or limited but have been disregarded and when the debt could not be recovered both from the firm's asset and from individual shareholders. This problem is much worse in case of companies with minimal number of shareholders and thin capitalization.

It has been discussed above that limited liability rule is not there without a drawback to cause. Thus, the presence of limited liability in certain business firms' can cause a risk of moral hazard[204]. This is to mean that it will encourage managers of such a limited liability firm to engage in over-risky endeavors knowing that the burden of the risk will fall up on other's shoulder[205]. On top of incentivizing managers to invest toward risky industries, the presence of limited liability will also make the shareholders not to or buy an insufficient insurance to cover

[204] Supra note 75, Hansmann, Henry and Kraakman, Reinier, states that limited liability encourages overinvestment in hazardous industries since it permit cost externalization. The managers would do so to make the investment attractive, but at the cost of others

[205] Supra note 59, at.7 See also supra note 76, at 55 which states"… much of the criticisms on limited liability focuses on the concern that the liability protection creates a greater incentive for managers of firms to engage in risky behavior."

the losses that their firm's might incur[206]. Thus, this way, the rule of limited liability while broadening the firm's profit margin, on the other hand, increases the chance of creditors incurring loss.

Thus, states have, with a view to mitigate such costs caused by limited liability rule, devised different mechanisms. Core among such mechanisms are piercing corporate veil, requiring larger capitalization and insurance scheme.

3.4.1. Piercing Corporate Veil

Piercing corporate veil, as said by many, is a scenario by which the separate legal personality of shareholders and a business firm and the limited liability protection of the shareholders have been disregarded. The cause for disregarding the corporate veil and making the shareholders or owners answerable to the firms' creditors claim is abusing the corporate veil and using it for illegitimate purposes to the disadvantage of third parties[207].

Thus, under Ethiopian laws too, there are certain provisions under the commercial code, which though not directly, but by deduction of the reading of the provisions, shows corporate veil of the companies can be pierced[208]. Rather than the implicit provisions of these articles, piercing corporate veil is shown nowhere under the code. Thus, under Ethiopian law one can only deduce that corporate veil can be disregarded and shareholders and directors can be held liable from their personal asset by the reading of articles 304(1) and 510(1) vis-à-vis articles 364, 366, 531 and 1160 of the code. While the first two provisions of the code tells us that members of a company 'are liable only to the extent of their contribution' the later pair of articles shows different scenarios by which a shareholder or member and directors of the company can be held liable towards third party from their personal asset in addition to what they have initially invested in the company[209].

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[206] Supra note 75, at 1889, These authors stated that most firms choose to buy a low coverage limit liability insurance What is more, on the contrary, it is argued that firms would most likely buy more insurance under unlimited liability in order to cover foreseeable losses. See also supra note 79, at 144

[207] Ottolenghi, **S.** *'From Peeping behind the Corporate Veil, to Ignoring it completely'*, 53*The Modern Law Review,* Blackwell publishing, 339 (1990) On Endalew Lijalem. P. 86

[208] See for instance arts 364, 531 & 1060

[209] See for instance article 531/1 which says 'shareholders of a PLC who has acted as a manager can be held liable for the debt of the firms' creditors when the asset of the company is found to be inadequate, see also articles 366 which states that directors are liable for the satisfaction of the claim of the creditors for failing to keep the company's asset intact and when the company's assets are insufficient to meet such liabilities

This being the case, how piercing corporate veil has been enshrined under Ethiopian law as means of enabling creditors claiming from the owners personal asset when the firm's asset has become insufficient is, however, problematic and does not seem to be adequate. The problem with piercing corporate veil, in addition to its clandestine recognition under Ethiopia's law, is that the creditors will be subjected to other costs. That is, in the process of getting the corporate veil pierced, the creditors and other stakeholders are required to pay court and lawyering fees. Thus, this leads creditors to look for another resort for their protection, such as larger capitalization and insurance.

3.4.2. Large Capitalization and Mandatory Insurance Scheme

As stated above, resorting to piercing corporate veil, in addition to the un clarity in its recognition and grounds setting it up, have its own problem and is sometimes, found to be inadequate. This could mainly be because the procedure of piercing corporate veil could be a lengthy process which also affects the creditors own pocket and even after they successfully able to pierce the corporate veil, it may be possible that they may be unable to collect their sum of money back, fully. Thus, as a compliment to, or as an option of avoiding the procedure of piercing corporate veil it is suggested that, there has to be another solutions than extending liability to shareholders. These other resorts are to make firms' have a larger capitalization, or to purchase insurance on behalf its creditors[210].

In relation to capitalization under the existing laws, Ethiopia has adopted a fixed sum of capital which companies needs as their startup capital. Accordingly, while SCs are required to have a capital of 500,000 ETB, PLCs are required to have 15000 ETB as their startup capital[211]. The only exception regarding capitalization is in relation to banks, in which cases, SC established to run a banking business are required to have a min startup capital of five hundred million[212]. The problem in relation to use capitalization and the figure stated under Ethiopian law as resort for creditors to claim their money in case asset of the firm is insufficient is that it is minimal.

[210] Supra note 77
[211] Supra note 19, art 306/1 and 512/1
[212] Directive on licensing and supervision of banking business directive number SBB /50/2011 minimum capital requirements for banks, article art 4

In this regard, one may raise the issue in relation to the legal reserve fund, which constitutes 20 of the legal capital[213]. It is true that 'something is better than nothing' but twenty percent of the legal capital will in no way be a sufficient fund to cover liability of the company, which can even be more than the total asset of the company. Thus, it is quite clear that the twenty percent legal reserve fund of the company is not adequate and does not work.

Finally, in relation to using a mandatory insurance scheme, though not for all, but at least in relation to some business organizations, as a remedy towards mitigating the moral hazards caused under the shadow of the limited liability, Ethiopian laws does not seem to have paid the attention it deserves. Thus, both under the commercial code as well as under those laws governing the registration and licensing of business organizations, mandatory insurance scheme is not mentioned. It is only recently that the NBE comes with a draft regulation which lays a legal frame work for the establishment of the Ethiopian Deposit Insurance Fund[214] twelve years after it is given the mandate of establishing deposit insurance fund[215].

As a summary of this sub topic, limited liability protection possibly invite managers of such a limited liability firms to engage in a risky investment without a fear of liability, which they will externalize to creditors. On the other hand, the way outs provided by the law to minimize such risks do not seem to be satisfactory. Thus, under Ethiopian law while piercing corporate veil is not expressly provided by the commercial code, it is being entertained based on some implicit provisions, only. Besides, its process could be tiresome and makes creditors to incur extra costs. In relation to capitalization as a remedy, what is provided by the commercial code is an outdated one. However, the draft commercial code is coming with adequate capitalization, which by it may not guarantee the creditors. Finally, there is no, but a draft regulation to establish one in relation to the banking sectors, mandatory insurance scheme requirement under Ethiopian law as a remedy to which creditors may resort in case the asset of the company is found to be inadequate to cover its liability.

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[213] Supra note 19, the commercial code arts 453&454 of the code requires the firms to put a sum of money from their annual profit until it is equal to 20% of their legal capital

[214] Gelila Samuel, Addis Fortune, 2020, AA https://allafrica.com/stories/202007290872.html last accessed Jan 13th, 2020

[215] The Banking Business Procl. 592/2008, art. 5(18) has given the NBE the power to establish deposit insurance fund

3.4.2.1. Affirmative Implications

Although business is highly dependent on making profit, for the well-functioning of the business and the market, it is quite important to balance the protections extended to the business firms on hand that of creditors on the other hand. Thus, while giving a limited liability protection to the business owners, it is also equally important and is beneficial to control that this protection is not abused by the business forms. Thus, it is important to protect the interests of the creditors and other stakeholders such as employees and customers of the business firm from the moral hazards that can arise from the hazardous endeavors in which the business owners could engage on by shielding the limited liability protection. Thus, when there is a balance between the protection given to the two sides of the business, the owners and the creditors and other stakeholders, then there will be a smooth functioning of the business in the market.

3.4.2.2. Negative Implications

When, instead of trying to balance the two competitive interests, the laws emphasis only on the side of the business owners or shareholders there will be certain negative consequences. Firstly, the business firms, when they are given a kind of absolute or a less restricted limited liability protection, they will be incentivized to engage in a more risky investment which they would not in the absence of such protection. This will in turn, can result in bankruptcy of the business firm itself and also affect interest of its creditors for good.

3.5. LIMITED SOURCE OF LIMITED LIABILITY

Be it in any state, having an alternative to incorporation or choosing a predefined form of entity in the search of limited liability is important in any legal system to protect the business entity and their owners. Especially, in a state like that of Ethiopia where the business community is yet to be developed, it is quite important to provide the business entities to have an alternative way of restricting their liability. The researcher, at this point of discussion, identifies that there is a problem of limited source for the business organizations to enjoy limited liability under Ethiopian laws.

As it has been shown above, under the conceptual overview of limited and unlimited liability, firms can be beneficiary of limited liability and also be subjected to unlimited liability, among others through their form of incorporation and using their freedom of contract. Especially in the

common law legal system, limiting liability through contractual terms is widely known[216], more specifically in relation to joint stock companies.

In a state where as a matter of principle, liability of the members of a business entity is to be determined by the choice of the type of firm they choose and incorporation, limiting liability through other means would only be possible as an exception, if any, when the law lefts a room. In the contrary, it is possible, only exceptionally, for shareholders and partners to make their liability unlimited, when their liability as a rule is limited.

Coming back to what the Ethiopian law says in relation to sources of liability of business organization and owners, it is understood from the reading of the code that owners will choose the available forms of business entities. Thus, while choosing the available modes of doing business provided by the law, the owners are indirectly choosing the liability that applies to them[217]. The issue here is whether once choosing a limited liability firm, owners could contract to unlimited liability, and whether once choosing an unlimited liability firm, the owners could contract to benefit from a limited liability.

Going through the laws governing liability of business organization in Ethiopia, it is nowhere mentioned that members can contract limited liability after choosing unlimited liability firm and incorporated as such. Thus, absence of rooms for negotiation by the owners to get limited liability would make it difficult for the owners to enjoy limited liability without going through incorporation.

In such scenario, for the business owners, who have chosen the wrong mode of doing business in relation to liability, be benefited from limited liability, they have to leave or dissolve the previous unlimited liability firm and come up with a limited liability firm. This is because, 'a state when granting limited liability to individuals regarding their business debts, it demands them to form an entity that is separate and distinct from them following a prescribed form and

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[216] Supra note 62

[217] Thus, for instance if five individual decides to establish and run a business in the form of a SC, then, their liability will be limited to their contribution to the company and on the other hand decides to run such a business in the form of a General Partnership, then their liability will be unlimited because, in case of partnership, the personality of the firm is not separate from personality of its shareholders

procedures fixed by the rules[218].' However, this may not be an easy task, in relation to time, resource and competition in the market.

3.5.1. Conversion and Amalgamation as a Remedy to the Limited Source of Limited Liability

Although it is not made clear by the code why members may convert their entity from one form of business to another and amalgamate, it is possible under Ethiopian law[219]. Thus, members can without the need to form a new legal person convert their BO from one to another[220] with a unanimous or majority vote[221]. Accordingly, under the commercial code, it is possible to convert general and limited partnership and share company to a PLC and a SC to a PLC[222]. Likewise, members of a business entity can amalgamate an already existing BO either by taking over or creation of a new entity[223].

Coming to the point whether conversion and amalgamation can serve as a way out for unlimited liability entities who wants to limit their liability without the need for incorporation, the answer is negative. This is mainly because, *firstly*, in case of conversion, although it does not necessarily, but possibly, cause creation of a new legal personality, the whole process has to be publicized, registered and the rules in relation to the newly formed BO will be applicable[224]. Thus for instance, if the members require converting a general partnership or a PLC to a SC, then they must prepare a new MoA and AoA that fits SC. *Secondly*, in relation to amalgamation, since the decision to amalgamate has to be reached by both firms, the challenge is double compared to conversion[225]. Thus, this and other similar procedures involved in the process of conversion and amalgamation makes it tiresome and equivalent to forming a new BO. Besides, the challenge in conversion and amalgamation is that it needs unanimous and or majority vote, even to decide whether to convert or not the BO from one to another form[226]. Simultaneously, it has to pass the

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[218] Robert A. Kessler, With Limited Liability for All: Why Not a Partnership Corporation? 36 Fordham L. Rev.235, 236-237 (1967)
[219] The commercial code Book II, Title VIII, articles 544-554 deals with conversion and amalgamation of business organizations
[220] Id, art 544/1
[221] Id, art 544/2
[222] Id, arts 545 & 547
[223] Id, art 549/1
[224] Id, art 544/5
[225] Id, art 549 and 550
[226] Id, art 544/2

opposition test to be made by their respective creditors[227]. Consequently, as it has been shown above, conversion and amalgamation seems to be far from being a solution to an already existing unlimited liability firm to enjoy limited liability without the firm going through an incorporation process.

Even if the conversion or amalgamation process becomes successful as a way by which firms can enjoy limited liability by changing the nature of the firm, it is however not without a problem. Thus, the problem in relation to this point is that, it will negatively affect interest of the creditor who have transacted with a business firm having unlimited liability and is later converted in to another form or is amalgamated and has become a limited liability business firm. On this point, while dealing with effects of conversion and amalgamation, the commercial code only says 'claims and liabilities of the firm which cease to exist will pass to the new firm or the firm taking over[228].' The fact that the code make the claims and liabilities of the old firm pass to the new firm is one step ahead but a step in an opposite direction in relation to interest of the creditors because, it changed the rule of the game only in favor of one of the parties, the firm. This is because; the firm is changed from unlimited liability to a limited liability firm no further clarification is made by the code to this effect.

3.5.2. Consequences of Limiting Sources of Limited Liability to Incorporation

If unlimited liability entity which is already in the market, to come up with a limited liability, as stated above, is required to newly incorporate another firm or convert itself to another or amalgamate with other firms, it could be detrimental to them. This is because, when such entities are required to go through incorporation, then they may loose and abandon their long built goodwill and reputation. Besides, since in the process of conversion and amalgamation a member who does not consent could withdraw itself, and this may affect integrity of the BO, especially when the dissenting members are members of the BoD or Managers. On the other hand, in the process of conversion or amalgamation, if creditors of such a firm were not actively following the steps of their debtor firm and has failed to timely oppose to the conversion or the amalgamation so intended, then it could also affect their interests[229].

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[227] Id, art 546/4 & 552

[228] Id, art 548/1

[229] This is mainly because; the process of conversion or amalgamation will result in change of the nature of liability of such a firm, mostly, from unlimited liability to limited liability. It is presumable that when members change their

3.6. FORMS OF IMPOSITION OF UNLIMITED LIABILITY

Is liability being imposed as joint and several or proportionally in the form of pro rata liability? What are its implications? Which one protects the shareholders and the creditors, in what kinds of scenarios and why?

Yet, another important concept attached with the rule of limited and unlimited liability, worth discussing is the one that relates to manner of imposing liability[230]. The discussion as to how should liability is imposed when liability is to be imposed in case the firm is unlimited liability firm or the firm is limited liability firm, but the protection of limited liability rule has been disregarded and shareholders and partners have become liable for their firms debt.

Thus, as it has been discussed in the third chapter of the thesis, liability when imposed on firm owners, shareholders or partners, it can be made in two most common ways; in the form of *joint and several liability* and in the form of *pro rata* or *proportional liability*[231]. To make point out of this part of the discussion, it is important to show which mechanism of imposing liability has been adopted by the commercial code as well as the upcoming draft code and what would its implication be.

Accordingly, as one can infer from the reading of the code itself, the current commercial code in its dealing with liability of partners in partnership as well as liability of shareholders in a Share company and a PLC, makes use of the word '*joint and several liability'* and has nowhere mentioned pro-rata liability[232]. Likewise, the code provides for liability of managers, when there are more than one managers, and directors to be imposed jointly and severally. What is more, the upcoming draft commercial code also provides for joint and several liabilities of partners, shareholders, managers and directors in case of liability[233].

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firm from general partnership to PLC or a SC, that is to seek limited liability. Thus, if the law does not provide, with due care, as to what should the effect of such conversions and amalgamations be, it will certainly affect interest of the creditors of such firms.

[230] Supra note 79
[231] Id
[232] See for instance, article 280/1, 309, 364/2 which states that partners, founders and directors are personally, jointly, severally and fully liable as between themselves and to the firm for the firms' undertakings.
[233] Art 221 and 342/2 of the draft commercial code for instance, also provides for a joint and several liabilities of partners in general partnership and members of BoD in a SC.

Thus, a problem lies with the implication that follows of using a joint and several or a pro rata liability rule. Accordingly, when liability is to be imposed to pay in the form of pro rata liability rule, either when corporate veil is pierced or when the firm is unlimited liability firm, then each members, shareholder or partners, shall equally be liable only in proportion to their shareholding in the firm[234]. Thus, since each shareholder is subjected to pay, in proportion to their shareholding in the firm, the implication is that, there is no possibility of each members being held liable for their co-members. Thus, there will be no chance for the creditor(s) to choose between a wealthy and poor shareholders or partners[235].

On the other hand, it has been shown that when liability of firm owners is imposed in the form of joint and several liability, then it means that each of the shareholders in company or the partners in partnership firm are liable to the full amount of the claim of the creditor(s). Thus, in such case, there would be a possibility by which a creditworthy shareholder or a partner may be held liable for his co-owner, shareholder or partners, because creditors tend to choose and sue a wealthy plaintiff[236].

3.6.1. Its Impact on Formation

As it has been stated above, when members, especially in partnership firms, are aware of the fact that at the end of the day when there comes liability and there is a possibility by which one of them could be held liable for their co-partner, when he is less creditworthy than they are, due to the joint and several liability rule, then, they will prefer to start the business only with a person having a deeper pocket. This seeming only a matter of choice of the partners, but would affect and makes formation of partnership firms difficult, as opposed to what the law intends.

3.6.2. Its Impact on Free Transferability of Shares

This fact, on the other hand implies that when a shareholder or a partner is subjected to pay a liability of his co-owner of the firm, he/she will try to find a way to avoid or at least minimize such risk. Thus, one way to do that is by selecting a wealthy shareholder or partner, than they are, when founding a firm or by welcoming only a transfer of share to a wealthy partner, when one of the existing members decide to transfer his share to another[237]. Thus, allowing transfer of

[234] Supra note 140, at 338
[235] Id
[236] See supra note 79, at 191
[237] Id

share only to a wealthy partner or in other words refusing transfer of share to a partner who can pay for it but who is less wealthy than they are, for the fear of an excess liability that they could be subjected to in case a wise creditor choose to sue them, will have e negative impact on a free transfer of shares, which is one among the core features of modern business entities.

Thus, seen in line with jurisprudence on the area, it is now time to say what is the implication of the fact that the joint and several liability rule adopted under the commercial code of Ethiopia. While the fact that a joint and several liability rule is imposed on shareholders and partners under Ethiopian laws gives their counterpart creditors a wide range of opportunity to sue and recover their debt from business firms, it is on the other hand impairing the free transferability of shares both in companies and partnerships, at least theoretically.

3.7. SHAREHOLDERS VIS-À-VIS STAKEHOLDERS MODEL

States in incorporating the limited liability rule to their laws governing business organizations may favor one of the two or balance between the interests of shareholders and that of the stakeholders[238]. Accordingly, a state is considered to favor interest of the shareholders when liability is highly limited and the grounds of mitigating it to the interest of the shareholders is less[239]. On the other hand when liability is unlimited, mostly, and when there is certain way outs for the creditors to resist the limited liability protection given to shareholders, it is considered stakeholders approach[240]. Thus, the stakeholders approach tries to protect interest of the stakeholder in two ways; first by requiring the neutrality of directors of the firm only just as a mere coordinators of the firms contributed asset and a profit so made. Secondly, this approach tries to advance interest of the stakeholders through representation of two or more this group of individuals in the board of directors.

Under Ethiopian laws, let alone representing stakeholders like creditors represented in the board of directors, it is only members of the company who can manage the firm becoming a director[241]. Thus it is even inconceivable to represent stakeholders in the board of directors. The only

[238] Supra note 10, at 441
[239] Id, at 441
[240] Id at 447
[241] The commercial code art 347/1 states that 'only members of the company manage the company'

representation allowed in the board of directors is for minority shareholders[242]. Again, in relation to requiring members of the board of directors to be neutral directors to the level of, only, coordinating the contributions and the profits gained by the company is far from being the case under Ethiopian laws.

Under Ethiopian law, it is impossible for directors, to be neutral, because in the first place only members will become a director[243], secondly directors are remunerated by the company from the firms asset which is to be calculated under general expenses[244]. Besides, directors are required to act diligently and in good faith to advance interest of the company. Hence, it is plausible to conclude that the members of the board of directors, as provided under the commercial code, cannot be neutral to the interest of the corporate members and that of stakeholder. This is basically because; they themselves have a vested interest from the firm since only members of the firm can become members of the BoD and because they are remunerated by the firm[245].

As a continuance of the above argument, it is also possible to say that the code lends a blind eye and a deaf ear to stakeholders other than creditors. That is, the code does not provide for how stakeholders other than creditors such as employees of the firm could claim their right, if any, in the presence of limited liability. It is not made clear by the code that these groups of stakeholders can demand piercing the corporate veil to claim their right, for e.g., unpaid wage or salary. Although one could say that issues in relation to employees of the firm can be answered by labor law and should not be made subject matter of laws governing business organizations, there is a scenario that demands the laws governing BOs to deal with such issues. Thus, for instance, if a number of employees went through the regular court procedure and sue a company using labor law and are unable to satisfy their claim due to lack of adequate asset, from which to claim performance, by the firm they must have another way out. That is to demand the corporate veil be pierced and collect their money from personal assets of the corporate members.

Finally, and most importantly, the fact the draft commercial code come up with Limited Liability Partnership and One Man Private Limited Company is, also, evidence showing that the code is pro shareholders than that of creditors. In other words, providing a limited liability protection to

[242] Id, art 352
[243] Id, art 347/1
[244] Id, art 353/1
[245] Id, art 353(1)-(7)

a single member company without requiring the same to provide some sort of guarantee is highly detrimental to interest of the creditors dealing with such firms.

CHAPTER FOUR

4. CONCLUSIONS AND RECOMMENDATIONS

4.1. CONCLUSIONS AND FINDINGS

Based on the problem stated and research questions posed and objectives set under the introductory chapter, this chapter targets to provide conclusions on the findings of the research. Accordingly, the research identifies six major legal gaps associated with limited and unlimited liability under Ethiopian laws.

The ***first*** major legal problem associated with limited and unlimited liability rule under Ethiopian law is in relation to letting corporate shareholders (as in the case of Holding Companies and Parent-subsidiary companies) enjoy limited liability without an equivalent measure to safeguard interest of creditors on the other side of the spectrum. The research shows that limited liability was not in the first place designed to protect corporate shareholder and to empower corporate power to own share in other limited liability corporations and thus, allowing corporate shareholders to enjoy limited liability would highly affect the interest of the creditors. Under Ethiopian laws, the problem is worsened by the fact that the commercial code requires parent companies to be liable if and only if the parent company has acted as director in the subsidiary company, and that too, when there is a fault. Thus, the research shows that, while parent company established a subsidiary in order to avoid liability, it is unwise and problematic to expect the same to act as a director and contract liability.

Secondly, the research has found out there is a gap in commercial code in relation to period of limitation within which a creditor whose interest is affected can invoke his right. Thus, the code has provides a couple of provisions dealing with period of limitations. These are the ones in relation to liability of founders to be barred after five years starting from the date when the creditors knew of the damage or the person liable, in this case the founder. The other one is in relation to previous assignees and subscribers who have transferred their share for a liability that follows such assigned or transferred shares. Thus, creditors who claims a right in relation to a liability that follows such shares, he has to claim it within two years since the assignment of such shares. On the other hand, other than these two cases, there is no law dealing with liability of BO

provides for a period of limitation as far as concerned the liability of managers, board of directors and also auditors.

Thirdly, absence of adequate and efficient way of mitigating moral hazards that could be caused under the guise of limited liability is another major problem associated with limited and unlimited liability under Ethiopian law found by this research. It stated that while limited liability broadens a profit margin of the firm, it increases the chance of creditors incurring a loss. Thus, the research uncovers three possible way outs available for creditors and other stakeholders in general. These are; piercing the corporate veil, larger capitalization, and mandatory insurance scheme. However, these way outs as enshrined under Ethiopian laws are found to be in efficient and the mandatory insurance scheme does not yet exist.

Fourthly, the research find out that there is a restricted source of enjoying limited liability, that is, only incorporation in the form of limited liability entity's recognized by the commercial code. The research shows that limited liability can arise from a number of sources other than incorporation. Especially, in a state where the business community is less developed, like that of Ethiopia, it is crucial to incentivize them by diversifying the way they can use to restrict their liability. Thus, among others, it is found that business firms can contract limited liability, other than through the choice of corporate forms, by establishing a subsidiary, becoming judgment proof and through a contract. In relation to this point, the research looks for amalgamation and conversion, may be as another way enabling BOs enjoy limited liability but has found that they are both ineffective and even affect the firm integrity and reputation. It is also found that the code left it unregulated as to how a creditor will claim a right from a limited liability BO which changed its nature of liability through amalgamation or conversion from unlimited liability to a limited liability firm.

Fifthly, the major legal problem in relation to limited and unlimited liability under Ethiopian law is on how to impose liability, on a limited liability firm when the corporate veil of such firm is pierced or when the firm is unlimited liability firm. Thus, the commercial code provides that liability shall be imposed on the corporate members, managers, directors, and also partners jointly and severally. However, imposition of liability in the form of joint and several liability is found to be problematic as it tends to affect the formation of the firm and free transferability of shares, thereafter.

Sixthly, in relation to whether the Ethiopian laws balances the interest of corporate members in one hand that of stakeholder such as creditors, employees and customers on the other hand, the research find outs that the commercial code seem to favor the interest of the corporate members. Thus, the research shows that the two major ways by which interest of stakeholders, especially of creditors, be protected against the limited liability rule through representation of creditors in the board of directors and through the requirement of having a neutral board of directors is missing under the commercial code. The commercial code provides that only members if the firm can be appointed as board of directors and since these members of the board of directors are to be remunerated by the firm itself it is found that they are not expected to and cannot be neutral. In addition, it is found that the grounds of piercing corporate veil under Ethiopian laws are not clearly specified and are in adequate, thus making the commercial code more of shareholders interest oriented.

Finally, in relation to the third research question, the research showed that there are some good lessons that Ethiopia should consider introducing in to her upcoming commercial code so as to give a solution to the problems so identified. Thus, what should be done in relation those problems identified; from what others have been doing, is provided as a recommendation of the research.

4.2. RECOMMENDATIONS

Cognizant of the fact the commercial code of Ethiopia is under revision and based on the above discussions and concluding remarks, the researcher recommends on the following points;

- Article 347(4) and article 364 (6) should be amended in order to make liable bodies corporate who acted as a director, thus in case of holding companies and parent-subsidiary companies, irrespective of whether they are at fault or not. This, would at least, helps the creditors in removing one protective layer the firms gets under limited liability rule.
- The legislators should, in the newly coming commercial code, clearly introduce a period of limitation within which creditors of the managers and the members of the BoD of the firm and that of the BO itself should exactly claim their right and after which they cannot.

- The legislators should come up with clearly provided grounds for piercing corporate veil, avoid the fixed legal capital and take to the end the adequate capitalization requirement included in its draft and it should also introduce a mandatory insurance scheme, in the course of amending the code. This would help creditors to easily safeguard their interests and thus build their confidence in business.
- The legislators should come up with an explicit rule which allows business owners (investors) to be able to contract limited liability without the need to undergo conversion or amalgamation process once they are incorporated with unlimited liability firm. This would help the firms not to lose their goodwill in the market when coming with a new legal personality. Besides, it will also save the firm from incurring additional cost in the litigation process.
- Article 548 of commercial code should be amended in order to make clear whether the creditor should undergo corporate veil piercing or not in relation to liability of unlimited liability firm that is converted to a limited liability firm, for the debt which has been contracted before the conversion. This makes the firms which undergo conversion not to do so with the view of escaping liability.
- The provisions, such as articles 280/1, 309 and 364/2 of the current commercial code dealing with form of imposition of liability should be modified so as not to hamper the formation and free transferability of shares. Thus, the upcoming commercial code should avoid a joint and several form of liability, at least in partnerships, and introduce a pro rata (proportional) liability rule so that partners are not frightened of bearing liability of their co-partners.
- The commercial code provision, art 347, dealing with constituencies of the members of the board of directors should be amended so as to enable creditors as a stakeholder of the company is represented in the board.
- The legislators in finalizing the upcoming Commercial Code should introduce an explicit ground by which employees who are creditors of the firm can claim their right failing the normal procedure provided under procedural laws in order to make the right balance between interests of the corporate members and that of stakeholders such as employees of the firm. To be more specific, the legislators should come up with a provision, in course

of mending the Commercial Code, which allows stakeholders other than creditors such as employees claim corporate veil pierced to the satisfaction of their claim.

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