Protection of Creditors from the Abuse of Limited Liability in Firms under Ethiopian Laws

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Abstract

Limited liability is an imperative part of modern company laws in many jurisdictions. Of course, the concept is common with some forms of partnership firms as well. In both companies and partnerships, limited liability allows the firm's partners/shareholders to limit their liability to the extent of their contribution within their firms. Nonetheless, unless it is effectively regulated, this 'privilege' could be potentially abused and as a result, the interest of the creditors of such firms could be affected. To regulate the potential abuse of limited liability, company laws of national jurisdictions have devised various mechanisms. Prominent amongst these mechanisms are; piercing a corporate veil, requiring larger capitalization, and mandatory insurance schemes. However, it remained an issue of how Ethiopian laws address this problem of abuse of limited liability. Therefore, this article makes a doctrinal analysis of how the relevant Ethiopian laws seek to protect the interest of firms' creditors in the event of such abuse of limited liability. The paper discovers that the use of piercing corporate veil, requiring larger capitalization, and the mandatory insurance requirements utilized in several jurisdictions as tools to mitigate the hazards of limited liability are inadequate and in some cases do not exist under Ethiopian laws. Thus, the writers recommend the incorporation of broader and clearer grounds for limiting the limited liability itself, adoption of adequate capitalization rule, and stronger implementation of the already started mandatory insurance scheme.

Keywords: Creditors, Limited Liability, Mandatory Insurance Scheme, Paid-up Capital, Piercing Corporate Veil, Ethiopia

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1. Introduction

Business organizations, especially companies, are distinct entities from their members and enjoy rights, and are subject to duties that are quite different from those of their members.[1] As a result, they own property and enjoy a continuous existence separate from their members. The fact that business organizations have separate legal personalities from those of their owners will make the owners of the business organizations entitled to limited liability. This means that they will only be liable to the extent of their contribution. Limited liability of the shareholders is one of the five core features that continue to characterize the corporate form of business, even today.[2] This rule of limited liability is considered as a form of 'owner shielding' and is a component of legal personality and also become almost a universal feature of the corporate form.[3] It does not, however, necessarily provide for how the interests of other participants in the firm as employees, creditors, other suppliers, customers, or society at large will be accommodated.[4] The concept of limited liability serves as a foundation for both the owners and creditors which are related to the business in one way or another. 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.[5]

The concept of limited liability is mostly tied to corporate forms due to the separation of personality of the firm and its owners. It is not however unique to corporations alone as other forms of business firms such as partnerships can also enjoy limited liability.[6] For instance; in limited partnerships, the liability of the limited partner is limited only to the extent of his contribution.[7] Limited liability, as a legal concept, is introduced into the Ethiopian legal system

[1]L.C. B. Gower, *Gower's Principles of Modern Company Law (*5th edn, Sweet and Maxwell London (1992)12 Cited on Igho Lordson Dabor, *Limited Liability: A Pathway for Corporate recklessness?'*, (Ph.D Dissertation, University of Wolver Hampton 2016) emphasis added.
[2] Henry H et al., 'Essay: *The End of History of Corporate Law'*, (2001) Georgetown. L. J 439, 439-440. 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.
[3]Reiner Kraakman et al, *The Anatomy of Corporate Law a Comparative and Functional Approach, (*2nd ed.Oxford Press 2009) 34 , see also Henry and Kraakman, *Supra note 2,* 440,
[4]Henry H., et al, Supra note 2, at 441
[5] Frederick G. Kempin, Jr, '*Limited Liability in Historical Perspective'(1960)*, ABLAB 11, 11
[6]Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 Univ. Ch. L. Rev. 89, 90 (1985)
[7]Larry E. Ribstein, '*Limited Liability and Theories of the Corporation'*, (1991) Md. L. Rev. 80, 81 Available at: http://digitalcommons.law.umaryland.edu/mlr/vol50/iss1/6

for the first time under the 1960 Commercial Code.[8] The concept, under the code, is understood to be a legal privilege that is given to shareholders in the 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. The New Commercial Code (hereinafter, The Revised Commercial Code) as well, recognized the concept even broadly. It provides for shareholders in share companies, private limited companies, and one member private limited companies and for partners in limited liability partnerships and for a limited partner in a limited partnership to enjoy limited liability separate from the liability of the business firms.[9]

Despite the critical role this concept of limited liability plays in modern firms; in order to protect the interests of the creditors and other stakeholders such as employees and customers of the business firm; it is necessary to make sure that it is not abused by firms. In the course of their operations, firms may engage in tricky endeavors by hiding behind the shield of limited liability protection, something they may not do in the absence of limited liability protection. In addition to incentivizing investors to invest in risky industries, the presence of limited liability will also make the shareholders not to buy it at all or buy only insufficient insurance to cover the losses that their firm might incur.[10] Besides, extending limited liability to corporate shareholders would even be worse and thus, double care has to be made on how to protect creditor's interest while allowing the corporate shareholders to shield under the wall of limited liability. In line with this understanding, the Commercial Code has provided instances in which the limited liability of shareholders in companies and of some partners in partnerships can be limited; i.e., shareholders in companies and some partners in partnerships will be personally liable for the firm's debts.

In spite of the wide range of concerns that limited liability poses to creditors, there were not many scholarly works on the issue. Yet, it is possible to find few works conducted and touched

[8]*The Commercial Code of the Empire of Ethiopia*, Proclamation No., 166/1960 (Here in after, 'The Commercial Code 1960' arts- 304/1, 510/1 and 296/1., It recognized that shareholders in Share Company and private limited companies as well as a limited partner in Limited partnership enjoy limited liability.

[9]*Commercial Code of the Federal Democratic Republic of Ethiopia*, Federal Negarit Gazzete Extra Ordinary Issue, Proclamation No. 1243/2021 (here in after 'The Revised Commercial Code, RCC), arts., 245/1, 211 and 495 which provides that the shareholders in such companies and partners under such partnerships firms are entitled to limited liability

[10]Henry Hansmann &Reiner Kraakman, '*Toward Unlimited Shareholder Liability for Corporate Torts*', (1991)*1 Y.L.J*, 1879, 1889, These authors argue 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.

on the issue of piercing the corporate veil and creditor's protection indirectly. The first one is the LL.M thesis by Asnakech Olinkamo under the title 'The Limits of Doctrine of Corporate Veil Piercing under Ethiopian Corporate Law: Law and Economics Perspectives'.[11] As can be grasped from the objectives of the study, the work is limited to the investigation of the adequacy of Ethiopian laws in lifting a corporate veil from an economic perspective.[12] The second one is an LL.M thesis conducted by Tigist Dessie under the title' The Protection of Corporate Creditors under Ethiopian Share Company Law in Light of International Recommendations'.[13] The paper focused on SCs creditors' protection under Ethiopian laws in light of international recommendations, such as the OECD. In her work, the author focused on how the law regulates contributions, dividend distribution rules, and the impact of cross-holding in relation to maintaining the capital of the company in the interest of the company's creditors.[14] The issues of how to protect creditors from the abuse of limited liability firms under Ethiopian laws remain unanswered.

Therefore, in line with such gaps in the literature and the law, it is imperative to analyze the mechanisms adopted in the commercial code and other relevant Ethiopian laws to regulate the abuse of limited liability by firms' shareholders and partners with a view to protecting creditors' interests. With this main objective, this article makes doctrinal scrutiny of the effects of abuse of limited liability by business organizations on such firms' creditors and the mechanisms adopted under the relevant Ethiopian laws to mitigate such abuses to protect firm creditors' interests.

In order to achieve the objective stated above, the article is divided into four core sections. The first section is an introductory section while the second section addresses a general discussion on the concept of limited liability in business organizations emphasizing its key functions, potential abuses, and mechanisms of mitigating such abuses with the rationale of protecting firm creditors' interests. The third section is a discussion on the limited liability of business organizations under the Commercial Code of Ethiopia while the last section makes an in-depth analysis of the

[11] Asnakech Olinkamo, '*The Limits of Doctrine of Corporate Veil Piercing under Ethiopian Corporate Law: Law and Economic Perspective'* (LL.M Thesis, Hawassa University 2020)
[12] Ibid, 10.
[13] Tigist Dessie,*'The Protection of Corporate Creditors under Ethiopian Share Company Law in Light of International Recommendations'*(LL.M Thesis, Bahirdar University 2020)
[14] Ibid, 14-16.

possible mechanism of tackling the negative effect of limited liability on creditors under Ethiopian laws. The final part concludes the paper and puts forth a way forward.

2. Limited Liability in Business Organizations: An Overview of Its Key Functions and Potential Abuses

2.1. 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.[15] Beyond incentivizing investors to invest without the fear of loss of their personal assets and also promoting economic efficiency by enabling the investors to take less risk and make more money[16] 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.[17]

For instance, 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/she faces in becoming a shareholder.[18] Thus, the 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 an unlimited liability scheme 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

[15] David LCohen, *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*? (1998) Okla. L. Rev. 427, 427 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

[16] Alexander J. Cooper, '*Unlimited Shareholder Liability through a Procedural Lens'* (1992) Harvard. Int. L. J. 390, 396-405

[17]Hameed Irshad, The Doctrine of Limited Liability and the Piercing of the Corporate Veil in the Light of Fraud: A Critical Multi-Jurisdictional Study 7 (2013). Available at SSRN: https://ssrn.com/abstract=2282306 or http://dx.doi.org/10.2139/ssrn.2282306 accessed on Oct 22, 2023

[18] Id

shareholders.[19] Hence, the simplification of the transferability of shares, by the presence of limited liability, serves as a check and balance against the power of the management of the firm. 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, nowadays the concept of limited liability is being contended as a *sine qua non* for an efficient and vibrant trading environment.[20]

2.2. The Potential Abuses of Limited Liability by Business Organizations and Mitigation Mechanisms

2.2.1. Abuse of Limited Liability

As it bestows on the corporate shareholders a number of advantages, limited liability is not also without a disadvantage seen in the light of creditors of the business firm. Thus, limited liability among others can cause a risk of moral hazard[21], which the managers of the firm may engage in over-risky endeavors knowing that the burden of the risk will fall on other's shoulders.[22] That is, the managers or the board members, after calculating the maximum amount of risk they can cover using the firms' assets without being required to cover it from their personal assets may gamble by taking a risky investment without even considering that interest of their creditors is at stake. On this point, what is more costly is that the party to whom the risk is transferred may be less well prepared to bear it than are the shareholders.[23] Thus, since the shareholders and the management of such limited liability business firms contract the firm after planning and knowing the possible risks, they are ready to face it while the creditors are not and this can be more disastrous.

On top of incentivizing managers to invest in risk industries, the presence of limited liability will also make the shareholders not to buy at all or buy insufficient insurance to cover the losses that

[19] Easterbrook and Fischel, *'The Economic Structure of Corporate Law' (1996)* 42-43. See also Jeffrey K. Vandervoort, '*Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*' (2004) DePaul Bus and Com. L. J. 51, 54
[20] Irshad, Supra note17, 8.
[21] Henry Hansmann et al., Supra note 10, at 1883
[22] Jeffrey K. Vandervoort, '*Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*' (2004) DePaul Bus and Com. L. J. 51, 55
[23] Susan E. 'Woodward, *Limited Liability in the Theory of the Firm', (1985)* J. Inst. & Theo. Eco, 601, 606 available at: http://www.jstor.com/stable/40750809 , last accessed September, 2023

their firms might incur.[24] Thus, in the absence of laws to regulate such limited liability firms with regard to what they should do with such limited liability and how to use it for the sake of the other party whose interest is at stake, the creditors, the firms could be reckless and may not at all buy or even if they do, buy an insignificant amount of insurance to cover such risks. This could mainly be due to the fact that the limited liability will incentivize the shareholders to engage in risky investments to be much more productive by externalizing costs. On the contrary, it is argued that firms would most likely buy more insurance when liability is unlimited in order to cover foreseeable risks, [25]with a view to making sure that they will not pay from their personal asset.

2.2.2. Major Mechanisms of Mitigating the Abuse of Limited Liability

It is quite clear that the limited liability rule is there in business organizations as a wall between the owners of the business organizations and their 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 at how states have tried to control or at least minimize the drawbacks of limited liability.

2.2.2.1. Piercing Corporate Veil

Cognizant of the cost that the limited liability rule is making creditors pay; states adopted a mechanism of disregarding the protection of the limited liability wall. Thus, on this issue, in the US, one of the prominent common law countries, it is accepted and recognized that under particular circumstances the rule of limited liability will and has to be abolished in order to advance the interest of the corporation's creditors.[26] 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.[27] Under Germany's corporate law, there is a similar rule and understanding that the general limited liability rule needs to be disregarded

[24]Hansman et al, Supra note10, at 1889, These (Hansman and Krakman) authors stated that most firms choose to buy low coverage limit liability insurance.
[25]Timo H. Kaisanlahti, '*Extended Liability of Shareholders'* (2006) J. Corp. L. Stu. 139, 144
[26] Carsten Alting, '*Piercing the Corporate Veil in American andGerman Law - Liability of Individuals and Entities:A Comparative View'*, (1995) TJCIL, 187, 190
[27]Maurice Wormser, '*Piercing the Veil of Corporate Entity'*, (1912) Col. L. Rev. 496, 497 Professor Wormser was the first to use the term., cited on Carsten Alting, above, supra note 26

regarding obligations of an *Aktiengesellschaft,* Stock Corporation, and a *Gesellschaftmitbeschraenkter Haftung (GmbH),* which is similar to a limited liability company.[28] This shows that that there is a common understanding both among the civil and common law legal families, that the 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 the limited liability rule can and has to be limited, the next move would be to distinguish the circumstances by which the limited liability rule 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, the limited liability wall would be disregarded when a situation that involves domination of the company[29], undercapitalization of the company[30], commingling of shareholders and the company's assets, and a disregard of corporate formalities has happened.[31]

2.2.2.2. Adopting Mandatory Insurance Scheme and Larger Capitalization

In addition to the rule of piercing the 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 the limited liability rule. This could mainly be because the procedure of piercing the corporate veil could be a lengthy process that also affects the creditors' own pocket and even after they are 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 for avoiding the procedure of piercing the corporate veil it is suggested that there has to be another 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 its creditors.[32]

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[28] Ibid

[29]Carsten Alting, Supra note26, 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.

[30]Ibid, 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.

[31] Ibid, 92.

[32] Irshad, Supra note21, 1889.

3. An Overview of Limited Liability of Business Organizations under the Revised Commercial Code of Ethiopia

Under Ethiopian laws, shareholders in Share Company, Private Limited Company, and One Member Private Limited Company are entitled to limited liability and thus, their liability to the firm is limited only to the extent of their share in the company. More or less, a new addition to the business firms with limited liability, across the globe as well as in Ethiopia is a limited liability partnership.[33] Therefore, partners in limited liability partnership as well as limited partners in limited partnership are also entitled to limited liability as discussed below under section 3.2. Under the following subsections, the writer tries to discuss the issue in brief and informative detail.

3.1. Limited Liability in Companies

The presence of limited liability in companies begins with the provision that defines both Share Companies and Private limited companies. Accordingly, the commercial code[34] defines a Share Company as; *"a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company."* On the other hand, the code also defined private limited companies with only a slight modification as follows:[35]

> *"A private limited company is a business organization whose capital is fully paid in advance, divided into shares and whose members are not liable for the debts of the company provided that they have paid up their contributions."*

As can easily be inferred from the reading of these definitional articles, both Share Company's and Private Limited Company's capital is fixed in advance and divided into shares before the coming into existence of the company, and thereby their liabilities are to be paid only from the company's respective asset. Therefore, the obligation of the shareholders is limited to making the contribution they pledged to make to the company when they subscribe to the specific

[33] The RCC introduces a new type of partnership, Limited Liability Partnership (LLP) for professional and complementary service providers with a limited liability. See the commercial code of Ethiopia, supra note 9, arts 172 and 21
[34] RCC*, art., 245/1*
[35] Ibid, *art.,495*

company's share.[36] The logical conclusion is that, once they paid the par value and any premium agreed upon, the shareholders are no longer liable to contribute anything to meet the company's debts and liabilities.[37] As it is shown, a defining feature of both Companies' is the limited liability of members saves for exceptional circumstances stipulated by law. Vesting this benefit of limited liability in shareholders, among others, might be necessitated by the need to shift some of the costs of innovation and its failures to the creditors and employees of companies.[38] Both Share Company and Private Limited Company per se has a separate legal personality. Thus, as a legal person, the companies have certain powers 'necessarily and inseparably incident to every corporation' such as the power to sue and be sued, the power to acquire capital by selling its shares, and the right to appoint agents.[39]

Unless it is strictly regulated, the limited liability of these Companies could be abused and misused in a manner that may affect the creditors of the company. One such danger of abuse of limited liability is that the management of the company may choose to engage in a more risky business. The directors and or managers may decide the company takes a deal that could be less profitable and costly only because they are protected by limited liability. Shareholders may also, with a view to abuse their limited liability, split a share company into different business entities and form sister companies so as to minimize the assets that will be available to the creditors of a company.[40] What is more, they may also enter into new related business by incorporating a new business entity.[41] However, it is to be noted that, the limited liability privilege given to companies as its characterizing feature is not absolute. Thus it can be disregarded through a procedure technically called 'piercing the corporate veil'[42]when such privilege of limited liability is proved to have been abused as stated above. The privilege of limited liability of companies can

[36] Ibid, *art* s, 245/2 and 495/1

[37]Endalew Lijalem, '*The Doctrine Of Piercing The Corporate Veil: Its Legal And Judicial Recognition In Ethiopia'*, (2012) MLR, 77, 98

[38]SeyoumYohanness *'On the Formation of Share Companies in Ethiopia'*, (2008) JEL, 105

[39] Ibid, p. 104

[40]Bruck Kefyalew, '*Lifting the Corporate Veil in Corporate Groups under the Commercial Code of Ethiopia*, Senior (LL.MThesis, AAU (2003), Cited on Endalew L. *The Doctrine Of Piercing The Corporate Veil: Its Legal And Judicial Recognition In Ethiopia*, 6, 1 MLR, 77(2012) p. 105, note 113

[41] Id

[42] Griffin Stephen, *Company law: Fundamental Principles,* (Pearson Longman Ltd, 4th ed., 2004),) Piercing corporate veil is a doctrine, first developed in the common law legal system (England) since the notorious case of the *Salomon v. Salomon & Co. Ltd* case in which it was decided that *"the company is at law a different person altogether from the subscribers to the memorandum; ....and it is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form*"

also be disregarded when the number of shareholders in the company is reduced below the legal minimum.[43]

3.2. Limited Liability in Partnership Firms

To begin with, the Commercial Code[44] of Ethiopia recognized four types of partnerships as a mode of business. Although it recognizes different types of partnership firms, the code does not, however, explicitly define what a partnership is. By looking at the definition given to business organizations by the code[45], it would be logical to describe and understand partnership as a business organization by which two or more persons come together through a Memorandum of Association[46] to engage in certain economic activities by joining their contributions in the form of money cash, skill, labor and or service and thus, to share from the profits to be made and a loss that could arise in the business.'

Since the concept of limited liability is tied to the legal personality which keeps the firm, its property, and its management separate from that of its owners, it is not well accustomed to partnership firms except in certain exceptional circumstances. One such exception is the entitlement of a limited partner in a limited partnership to a limited liability. These days, however, there are developments in this regard to which our commercial code also subscribed. That is, the commercial code comes up with a new form of partnership having limited liability, limited liability partnership.[47] This partnership firm shares an important feature of companies as it has a legal personality that is separate from that of the partners and thus will not be affected by the death and bankruptcy of its partners.[48]

[43] *RCC*, art 495/4 and 498, the code states that the minimum number of shareholders required for share companies is five (5) while it is two for private limited companies unless it is a one member private limited company.
[44] *RCC*, Art.174
[45] RCC, art., 178/1 defines business organizations as 'an association established through a memorandum of association by persons who bring together contributions for the purpose of undertaking an economic activity in cooperation and of participating in the profit made.'
[46] Ibid, art., 173/1 defines a memorandum of association as 'an instrument drawn up to establish a business organization.'
[47] Ibid, arts, 146 and 221/1 Article 221/1 defines limited liability partnership as a business organization formed by two or more persons to render professional service and services complementary thereto in which the liability of partners is limited to the amount of their contributions.
[48] Ibid, art.,222

In general, in a partnership two partners could enjoy limited liability. These are; partners under a limited liability partnership[49] and limited partners in a limited partnership.[50] While liability is limited as a matter of principle in the case of partners in limited liability partnerships the liability of limited partner is only exceptional. As in the case of limited liability in companies, a limited liability accorded to partners in the above forms of partnerships is not without restriction. Partners under limited liability partnerships can be held liable without limit among others when they commit fault and cause damage irrespective of fault.[51] Likewise, the limited partner in a limited partnership can also be devoid of his limited liability privilege and be subject to liability without limit when such partner allows his name to be used in the partnership firm's name and when such firm contracts debt.[52] In a nutshell, shareholders under the commercial code enjoy limited liability as a matter of principle, both in the case of Share Companies and Private Limited Companies, including the Private Limited Company with a single member. Similarly, partners under some form of partnership enjoy limited liability. However, limited liability can be restricted both in companies and partnerships whenever it exists and shareholders in the company as well as partners in such partnership firms can be subject to liability without restriction.

4. Protecting Firm Creditors against the Abuse of Limited Liability under Ethiopian Laws

As pointed out above, the limited liability rule is subject to potential abuse by firms[53]. Although the rule broadens a firm's profit margin, it also increases the chance of creditors incurring loss as well. Hence, intending to mitigate such costs caused by a limited liability rule, company laws often devise several mechanisms. The core mechanisms recognized in the vast majority of jurisdictions are; piercing the corporate veil and requiring larger capitalization and insurance schemes. This section scrutinizes the position of Ethiopian laws on the issue of regulating the

[49] Id, art.,221/1
[50] Id,, art.,212
[51] Id, art.,228/1
[52] Id, art.,213/3
[53]Hansman et al, Supra note10, 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: See also David L., Supra note 15 at.7: See also Vandervort, supra note22, 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."

abuse of limited liability in firms in general and argues if the common mechanisms recognized in most national company laws are adequately recognized under the relevant Ethiopian laws.

4.1. Piercing the Corporate Veil

Piercing corporate veil is a scenario by which the separate legal personality of shareholders and business firms and hence the limited liability protection of the shareholders can be disregarded. When firms abuse the corporate veil and use it for illegitimate purposes to the disadvantage of third parties; the veil will be removed and the shareholders or owners will be held answerable to the firms' creditors' claims.[54]

Under the Revised Commercial Code there are certain provisions, which albeit not directly, but by deduction of the reading of the provisions, show the corporate veil of the companies can be pierced.[55] The code nowhere clearly stated, piercing the corporate veil. As a result, under the Ethiopian laws, one can only argue that corporate veil can be disregarded and shareholders and directors be held personally liable from the readings of articles 245(1) and 495(1) vis-à-vis articles 329, 330,502, 516, 543 and 705 of the Revised Commercial Code. While the first two provisions of the code tell us that members of a company 'are liable only to the extent of their contribution' the later pair of articles shows different circumstances 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.[56] However, how piercing the corporate veil may serve as a means of enabling creditors to claim from the owner's personal assets when the firm's assets become insufficient to cover their claims is unclear. The problem with piercing corporate veil, in addition to its clandestine recognition under Ethiopian laws, is that the creditors will be subjected to considerable costs in the process of getting the corporate veil pierced. For instance, creditors and other stakeholders are required to pay court and lawyering fees. In addition to the unclear legal recognition of the grounds for piercing corporate

[54]Ottolenghi, **S.** *'From Peeping behind the Corporate Veil, to Ignoring it completely'* (1990) *The Modern LR,*, 339 Cited on Endalew L. *The Doctrine Of Piercing The Corporate Veil: Its Legal And Judicial Recognition In Ethiopia*, 6, 1 MLR, 77, 86(2012)

[55] See for instance arts 329, 516&705

[56] 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

veil, the courts in Ethiopia are not proactive as such in applying the doctrine[57]. This will lead creditors to resort to other mechanisms such as larger capitalization and insurance schemes the discussion in the following sub-sections reveals.

4.2. Large Capitalization Requirement

As stated above, resorting to piercing corporate veil, in addition to the lack of its clear recognition and the grounds to invoke, is mostly, found to be inadequate. This could mainly be because of a lengthy process of piercing the corporate veil which could potentially affect the creditors' own pocket. Besides, even after they successfully 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 lengthy procedure of piercing corporate veil, it is often suggested that there has to be alternative solutions instead of seeking a personal liability of the shareholders. One such other resort is to make business firms have a larger capitalization.[58]

In relation to capitalization under the existing laws, Ethiopia has adopted a fixed sum of capital which companies need as their startup capital. Accordingly, while Share Companies are required to have a capital of 50,000 ETB, Private Limited Companies are expected to have 15000 Ethiopian Birr as their startup capital.[59] There are two exceptions to this minimum paid-up capital under other laws. The first one is in relation to banks; a Share Company established to run a banking business is required to have a minimum startup capital of five billion birr.[60] The second one is in relation to companies engaging in leasing capital goods are required to have a minimum paid capital of two hundred million birr (200,000,000) if the company targets lessees having capital goods finance requirement of up to one million birr per single lessee[61] and four hundred million birr (400,000,000) if the company targets lessees having capital goods finance requirement not exceeding thirty million.[62]

The problem in relation to the use of capitalization and the figure stated under Ethiopian laws as a means of helping creditors to claim their money in case assets of the firm are insufficient is that;

[57]Endalew L., Supra note 37. The author stated that the fact that Ethiopian courts are not proactive enough could be attributed to the fact that Ethiopia follows codified legal system and the perception that says the judges role is only to ascertain the law as it is
[58]Susan, supra note 23
[59]*RCC*,art.,347/1 and 496/1
[60]Minimum Capital Requirement for Banks (Amended) Directive No.,SBB/78/2021, art 4
[61]Minimum Paid up Capital Requirements Directives No., CGFB/07/2017, art 4/1
[62]Ibid, art 4/2

it is minimal except in the cases of the banking and capital leasing business companies. However, one may, in this regard, raise the issue in relation to the legal reserve fund, which constitutes five percent (5%) of the legal capital[63] as a safety net to which creditors could resort. The writers admit to the saying "something is better than nothing" but five percent of the legal capital will in no way be logical to be considered as a sufficient fund to cover the liability of the company, which can even be more than the total asset of the company. Thus, it is plausible to conclude that the larger capitalization requirement in most cases, with the exception of banks and capital leasing companies, is not adequate in protecting creditors against the abuse of limited liability.

4.3. Mandatory Insurance Scheme

In relation to using a mandatory insurance scheme for some business organizations as a remedy for mitigating the risks caused by the abuse of limited liability by firms, the Ethiopian laws do not seem to pay enough attention. Both under the old commercial code as well as under those laws governing the registration and licensing of business organizations, a mandatory insurance scheme is never mentioned. However, recently there have been some moves towards the introduction of mandatory insurance by business organizations. The first is the one introduced by the revised commercial code of Ethiopia. The code, in relation to limited liability partnerships, requires the firm to have insurance coverage[64]. The provision states that 'the partnership shall have insurance coverage to make good damage caused by professional fault committed by the partners or employees'.[65] As it can be possibly inferred from the plain reading of the provision, this mandatory insurance required by the code is only in relation to compensating the damages caused by the professional fault of the partners or employees of a limited liability partnership. Yet, this compensation is intended for the customers or clients of the partnership firm and may not be available to the firm's creditors. Besides, the code is silent as to the amount of the insurance and leaves it to be determined by another organ.[66] The revised commercial code also does not clarify whether such insurance is required of the partners during the formation or later during the operation of the partnership firm.

[63]RCC, art 433&434 of the code requires the firms to put a sum of money (5%) from their annual profit until it is equal to 5% of their legal capital. This amount is lesser than the one required by the old commercial code which was 20% of the company's legal capital (See art 453 and 454 of the Commercial Code 1960).
[64]*RCC*,art 228/4
[65] RCC, art 228/4
[66] RCC, art 228/4

The second one is in relation to the financial institutions[67] in which the financial institutions are required to buy insurance on behalf of their depositors. The Council of Ministers enacted a regulation to establish and regulate the operation of the Ethiopian deposit insurance fund as per the National Bank of Ethiopia Establishment Proclamation No. 591/2008 (as Amended). As per this regulation, all financial institutions are required to become a member of the insurance fund so established[68] and accordingly, these financial institutions are required to pay to the fund's account an amount of premium to be determined by the fund to be paid to the depositors in an insurance event[69] when a failed financial institution[70]license is revoked. The problems with this scheme of mandatory insurance are twofold. First, it covers only financial institutions by disregarding other creditors. Secondly, within financial institutions themselves, it is applicable only when the license of such financial institution is revoked on the basis of obtaining a license based on false information or when the institution has failed to commence operations within 12 months after receiving its license.[71] Thus, it seems it is in vain that deposit insurance is required for a financial institution that does not begin operation because it is no way logical to expect such financial institution to have depositors, as their creditors.

Concluding Remarks

The limited liability privilege in business firms potentially invites managers of such firms to engage in a risky investment without a fear of liability, which they will in fact externalize to creditors. While limited liability broadens the profit margin of a firm, it also increases the chance of creditors incurring a loss due to an abuse of limited liability.

[67]*Establishment and Operation of Ethiopian Deposit Insurance Fund Council of Ministers Regulation* No.482/2021, Federal Negarit Gazette No.12 February 16th, 2021, art 2/11 defined financial institution as a commercial bank or a microfinance institution licensed by the National Bank

[68] Id, art 24/1

[69] Id, art 21 states that "an insurance event shall occur on the date when the National Bank announces the revocation of a business license of the failed financial institutions and the Fund undertakes to pay the insured deposits under this Regulation"

[70] Id, art 2/10 defined 'failed financial institution' as 'a member financial institution that has been notified the revocation of the business license by the National Bank as per Article 32 and 40(2) of Banking Business Proclamation No. 592/2008 as amended by Banking (Amendment) Proclamation No. 1159/2019 and Article 8 of Micro Financing Business Proclamation No. 626/2009 as amended by Microfinance Business (Amendment) Proclamation No. 1164/2019'

[71]See art. 21 together with art 2/10 of the regulation and with art 32/1 of the Banking Business Proclamation No. 592/2008 as amended by Banking (Amendment) Proclamation No. 1159/2019

This paper uncovers three major mechanisms devised by the company laws to protect firm creditors against such abuse. These mechanisms are; piercing the corporate veil, larger capitalization requirement, and mandatory insurance scheme. While piercing the corporate veil is not expressly provided by the revised commercial code, there are provisions that implicitly recognize this mechanism. Yet, the process of piercing the veil in practice could be tiresome and also cause creditors to incur extra costs. Besides, the courts in Ethiopia are not proactive enough to entertain such matters. In relation to capitalization as a tool to protect the firm creditors, the provisions of the old commercial code were outdated and less effective in serving the purpose of mitigating the possible risks caused by the abuse of limited liability by firms. The revised commercial code, while it was expected to come up with adequate capital requirement, tends to fix a specific figure and hence repeat the mistake of the old commercial code. In relation to the requirement of an insurance scheme as a tool for protecting a firm's creditors from abusing a limited liability, the revised commercial code requires only limited liability partnerships to have a mandatory insurance requirement; while a deposit insurance fund is established only for creditors having deposits in the financial institutions. The discussion above reveals that the three major mechanisms known for effectively protecting creditors against the abuse of limited liability by firms are recognized inadequately and in a less comprehensive fashion under Ethiopian laws. Hence, they are ineffective in protecting firm creditors against the risk of abuse of the limited liability privilege.

Finally, this article recommends, first, that it would be in the best interest of firm creditors that the legislative amendment be made by the lawmaker to provide clear grounds for piercing the corporate veil. Secondly, the fixed minimum paid-up capital requirement needs to be avoided, and the legislative revision be made to shift toward the adequate capitalization requirement which depends on the nature of the intended business endeavor of the business organizations. Finally, the mandatory insurance scheme required for limited liability partnership should be extended to all forms of business organizations enjoying limited liability. Also, it is imperative to broaden the grounds on which the deposit insurance fund would be made payable to the depositors of financial institutions. This way, the writers believe that creditors' interests will be better protected against the potential abuse of the limited liability privilege by firms.