Regulation of Group of Companies in Ethiopia: A Comparative Overview

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Abstract

Companies that are organized in a group aim at leveraging the market share, mitigate liability or facilitate long-term management efficiency. The reasons that make group establishment attractive for the parent company can be a basis for concern to other stakeholders, mainly, minority shareholders and creditors of the subsidiary company. The strict application of separate existence of a company and directors’ fiduciary duties towards their companies –applicable in cases of single entity companies– may be difficult in the case of group companies. States, therefore, devise regulatory mechanisms to protect the subsidiary company and its minority shareholders and creditors while at the same time protecting corporate freedom and entrepreneurial reality. Ethiopia has introduced regulatory rules regarding group company (parent-subsidiary company). The objective of this article is to discuss the nature and regulation of group company as specified under the new commercial code and in comparison, with other countries’ laws. The article argues that the rules stipulated are not designed to adequately protect the interests of the subsidiary and its stakeholders. It also argues that the liberal interpretation of the provisions governing group companies to include the application of rules governing single company can contribute to potential protection rules missing under the sections in the group company.

Key terms:
Group companies · Parent-subsidiary · Creditor protection · Minority shareholder protection · Power to direct

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1. Introduction

Companies are organized and protected as a group as a result of entrepreneurial reality to respond to traders’ aspiration for growth, isolate risks from each part within the segregated entity while the rest of the enterprise may remain unaffected in the course of managing large enterprises with comparatively little investment. The same factors that make a group structure attractive for a parent company can be the basis for concern to other stakeholders. While the activities of subsidiaries are conducted in the interest of the whole group, liability arising from these activities is limited to the assets of the individual subsidiary.

Although entrepreneurial reality justifies parent company’s direction of its subsidiary, some cases of regulation such as when “cases of directions to the subsidiary to act in a way which is disadvantageous to it (and its creditors and outside shareholders) in order to benefit the parent (and its creditors and shareholders)” may be deemed necessary. It is, therefore, common for countries to regulate corporate groups to protect the subsidiary, its shareholders, and creditors and even the minority shareholders of the parent company. Some countries regulate them using the general creditor protection rule\(^1\) and others develop distinct rules\(^2\) to mitigate the setbacks of group companies.

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\(^2\) Germany regulates group structure using distinct rules. Ibid.
Ethiopia opted to set specific rules to regulate group companies under the Commercial Code of 2021. Though some provisions that govern single entity companies are made applicable to group companies, most important safeguards are left out exposing the protection of the subsidiary company and its stakeholders to uncertainty. Moreover, extensive power of direction and intervention bestowed upon the parent company makes the management of the subsidiary under the mercy of the parent company and its directors. Although the independent directors of the subsidiary, not appointed by the parent company, are not obligated to follow the parent's directives, this autonomy may prove ineffective against a dominant parent company as the majority shareholder.

Accordingly, the law has gaps in providing safeguard measures to the subsidiary, its management and its stakeholders including the minority shareholders and creditors. Therefore, beyond taking legal amendment measures, interpretation of the provisions governing group companies to include the application of rules governing single company –such as safeguards stipulated under Article 295 (obligations of shadow directors)– can contribute to potential protection rules that are missing under the sections in the group company.

The next section and Section 3 deal with the salient features of and the rationale for the establishment of group companies. Sections 4 to 8 examine the regulatory regime of group companies in Ethiopia followed by a brief conclusion.

2. Definition and Nature of Group Companies

2.1 Definition

Phillip Blumberg describes corporate groups as “enterprises organized in the form of a dominant parent corporation with scores or hundreds of subservient sub-holding, subsidiary, and affiliated companies.” These enterprises involve a “single unity of purpose for a common design” and conduct a single integrated enterprise under common control and often under a “common
In practice, they share a common purpose whether or not the parent keeps a tight restraint over the subsidiary; the parent may assert full control at any moment if the subsidiary fails to act in the parent's best interests.7

Group companies are, interchangeably, called parent-subsidiary8 or holding-subsidiary companies9 in different jurisdictions. The holding and parent companies do not have differences in controlling the operations of the subsidiaries or undertaking, one or more of the trading activities of the group.10 The integration may be caused by agreements, also called “enterprise agreements” or control of majority rights, also called a default concern in German Law.11 Under German law, a holding company is created if one or more persons are subject to common management by another person.12 It is assumed that the controlling and controlled persons form a holding-type group (or a holding company). Persons may also be subject to common management on the basis of a controlling agreement to cover relations between a controlling person and the person or persons as a group controlled by it (i.e. “the controlled persons”).13

However, as it is easily discernible, each corporate entity has its own legal personality, and the management of corporations owe specific duties to their company and its shareholders.14 When, however, each separate island is entombed into “a single integrated enterprise under common control and often under a common public persona,” by equity participation or contractual obligations, various tensions between independence and interdependence arise.15 Most of these tensions make themselves felt as particular problems in

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6 Blumberg, supra note 4, p. 192
7 Considine, supra note 5.
8 Davies et al, supra note 1.
9 In UK’s company legislation the holding subsidiary nomenclature was used to define group companies, currently, however, the CA 2006, the two terms have slightly different meanings, the definition of a “parent” company being broader than that of a “holding” company; and the term “parent” company being used in relation to company accounts and that of “holding” company elsewhere where the Act recognizes group situations, see Ibid.
10 Ibid.
12 German Stock Corporation Act, 2016, Section 66.
13 Id., section 18.
14 Cahn & Donald, supra note 11, pp. 827-860.
15 Ibid.
the law of corporate groups.16 This is because business decisions may be taken on the basis of maximizing the wealth of the group as a whole (which usually means the value of the parent company), rather than of “the particular subsidiary of which the claimant is a creditor.”17

The Commercial Code of 2021 (the Code) sets out distinct rules18, like the German Law, to regulate group companies. It defines group companies as “a set of companies comprising the parent company and all its domestic and foreign subsidiaries unless otherwise provided by law.”19 Looking at this provision, one might assume that Ethiopia preferred the parent-subsidiary terminology to define what group companies denote. The last phrase, “unless otherwise provided by law” is not clear whether other group companies can be named with a different name such as “holding companies.” Moreover, the Code defines a holding company as “[a] company that does not itself conduct operations to produce goods or render service by engaging in activities specified under Article 5 of the Code but holds shares in other business organizations that do so shall be deemed to be a trader.”20 This definition frames a holding company differently from a parent company defined under Article 550(3) where “control” is an essential element.

The fact that the parent and its subsidiary are traders is recognized as per Article 5 of the Code. The complication, however, lies on the fact that even a holding company can engage in commercial activities by itself.21 Caution is needed with regard to the interpretation of Article 559, –a provision specifically set to govern parent-subsidiary company– which refers to Articles 358 and 381.22 Does this mean that the Code preferred to use holding company and parent company interchangeably? If this is so what will be the effect of Article 9?

What makes the case more complicated is that the instance of the control is also used to define a holding company under Article 382(3) and Article 313(1)(C) of the Code. Article 382/3 specifically states that “…where the

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16 Ibid.
17 Davies et al, supra 1.
19 Id., Article, 550(1).
20 Id., Article 9(1).
21 Article 9(2) states that “Notwithstanding the provision of Sub-Article (1) of this Article a holding company may directly produce goods or render service.”
22 The Code utilized the name of holding company under Articles 358, 353, 313, 307, 9, 382 and 431
company is a holding company or has direct or indirect effective control over other companies” … and the latter provision also shows the possibility of a director to hold a share or shares in a holding company. Since a director can be a legal person, will there be a possibility for a cross-shareholding to exist in this scenario? Moreover, the need to consolidate the accounts of a holding company and its subsidiary for accounting and tax purposes may be unnecessary where the holding “company and its subsidiaries carry out the business of such a differing nature that they may not reasonably be deemed to form a single enterprise.”

Here, it can be discerned that not only may the holding company engage in business but also the area of business can be different from what its subsidiary has been engaged in. Therefore, the Code employs the parent-subsidiary and holding-subsidiary companies interchangeably to define corporate groups. In this article, unless specifically indicated otherwise the name Parent Company is applied.

Other laws employ different terminology to define Group Company for tax, accounting and registration purposes. For example, the Commercial Registration and Licensing Proclamation No. 980/2016 employs “holding company” and defines it as a company incorporating “two or more limited liability companies and issued with a special registration certificate and managed by holder”. There is a visible difference between these two provisions because the Code states “comprising a controlling power” as a necessary element the Proclamation gives emphasis to management by the holder.

2.2 Nature

The issue at hand is whether ownership dictates management in group companies, just as it does in a single company. The issue that companies are distinct legal persons separated from their owners is a conventional understanding. Hence whether a parent company with significant ownership in the subsidiary will be entitled to appoint directors or be appointed as a director can be in conformity with the company law. If this is the case, does the definition in Proclamation No. 980/2016—that envisages the existence of

**Footnotes:**

23 Id., Article 382(3).
24 Id., Article 313(1)(c).
25 Article 296(4).
26 Article 431(3)(b).
27 The Federal Democratic Republic of Ethiopia, Commercial Registration and Licensing Proclamation No. 980/2016, Art. 2(40).
28 Id., Article 2(40).
the power to manage the subsidiary as a prerequisite for acquiring the status of parent company—hold true?

Even in wholly-owned subsidiaries\textsuperscript{29}, the principles of limited liability and separate identity can impact the subsidiary's creditors. This holds even when the parent company intervenes in the subsidiary but still invokes these principles. However, if the parent company holds controlling ownership of shares in the subsidiary, there may be a possibility that management by the parent will negatively affect shareholders of the subsidiary who have no interest in the parent company.\textsuperscript{30} It is because the Code recognizes group identity resulting from share ownership or share ownership plus controlling vote.\textsuperscript{31}

The Federal Income Tax Proclamation No. 979/2016\textsuperscript{32} recognizes the possibility of a “Group Company existence” by focusing in terms of share ownership. It provides: “underlying ownership in relation to a body means a membership interest in the body held directly or indirectly through an interposed body or bodies by an individual or by an entity not ultimately owned by individuals.”\textsuperscript{33} Moreover, Article 550(2) defines a “subsidiary” as a company subject to the control of another company, the “parent” company, either directly or indirectly through another company. A “parent” is also defined as a “company that has subjected another company to control either directly or indirectly through the instrumentality of another company.”\textsuperscript{34} The term control in these sub-articles is defined under Article 552. Accordingly, the elements of ‘control’ include:

- Formulating the financial and operating policies of a subsidiary (Article 552/1)
- Administering the financial and operating policies of the subsidiary (Article 552/1 and Article 552/3/b)
- Ownership of more than half of the voting shares of the subsidiary (Article 552/2)
- Agreement with shareholders (Article 552/3/a)
- Controlling the management of the subsidiary (Article 552/3/c)
- Actual control of the business by voting (Article 552/3/d)

\textsuperscript{29} Commercial Code, \textit{supra} note 18, Art. 551.
\textsuperscript{30} This is further discussed in section 6 of this article.
\textsuperscript{31} Commercial Code, \textit{supra} note 18, Article 552(2) & (3).
\textsuperscript{32} FDRE Federal Income Tax Proclamation Number 979/2016, Article 2/25
\textsuperscript{33} Ibid.
\textsuperscript{34} Commercial Code, \textit{supra} note 18, Article 550(3).
In general, control entitles the parent company to provide rules and policies, administer them; direct the management and control the business. These powers may result from an agreement or a default law. What triggers the dominant influence may be difficult to decide beforehand but, in most jurisdictions, a majority holding creates a presumption of such influence. Another factor may be the ability of the management of one company to appoint or remove the management of another—which can exist even without a majority holding.

The fiduciary duties of the management of the parent company may be required to secure the group’s strategic interests. In such cases, conflicts of interest between the duty of the subsidiary’s management to serve the subsidiary’s best interests and the influence of the dominating person to secure strategic interests will certainly arise. To regulate such conflicts of interest, legal safeguards should be available. The difficult question arises when to put such safeguards, or whether the possibility of influence or its actual exercise is determinative. Under German Law, the possibility of influence and not its actual exercise is determinative.

The provisions of the Code are ambiguous whether one should presume influence or if actual control is mandatory. Article 552(2) states that merely possessing more than half of the voting capital in a subsidiary does not inherently indicate control. Specifically, it provides, “the legal effects of ‘control’ shall not follow if, in exceptional circumstances, it's evident that such ownership does not equate to control.” Nonetheless, Sub-Articles 3(c), 3(d), and 4 appear to lean towards presuming control when the parent company has the capability to appoint or remove over half of the management or carries the majority of votes at general meetings or an equivalent body. Still, relying on this perspective is debatable, particularly as Sub-Article 3(d) emphasizes a conjunction of majority votes and tangible control.

The debate on the legal status of and realities about group companies “has ossified into a contest between the view of a group of companies as separate and autonomous individual entities and the view of such a group as a single

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35 Id., Article 552.
36 Cahn & Donald supra note 11, p. 840.
37 Ibid.
38 Ibid.
39 German Stock Corporation Act, supra note 9 Section 17, see also Cahn & Donald, supra note 11, p. 841.
40 Article 552(3) & (4).
economic unit.” These realities raise issues involving directors’ obligation to their corporation *vis-à-vis* their duty to the entire group; directors’ independent judgment versus following instructions of the parent company; subsidiary company’s debts versus the parent’s duty to compensate. This is because for the interests of the group, the parent may instruct the board of the subsidiary to do something which is not in the best interests of the subsidiary or it may allocate a business opportunity to a certain subsidiary in preference to another which can maximize the benefit for the group. Finally, if a subsidiary falls into insolvency, the parent may refrain from rescuing it, even though the group has sufficient funds to do so. The application of the separate entity and limited liability doctrines without the consideration of a sophisticated and nuanced regulatory system may, therefore, not result in a sensible policy term.

### 3. Rationale for Grouping

The purpose for which a business organization may opt to be organized as a group than a single business entity can be explained by manifold justifications. According to Cahn and Donald, traders prefer group organization to single entity model for at least five reasons. The first factor can be traders' aspiration for growth, because this model allows them to reinvest and multiply their capital in multiple organizations with multiple divisions. Secondly, grouping enables limited liability; by segregating parts of the enterprise into separate legal entities, investors isolate risks from each part within the segregated entity while the rest of the enterprise may remain unaffected.

*Thirdly,* Group-Structure allows control of large enterprises with comparatively little capital. For example, if parent Company A acquires 50.1 percent of the shares of Corporation B, and Corporation B acquires similar rights in Company C this entitles Company A to determine all shareholder decisions that require only a simple majority of the votes in B and C. *Fourthly,* a streamlined/shallow hierarchy under a group structure promotes quicker decision-making and enables the management of the holding company to

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42 Cahn & Donald, supra note 11, p 828.
43 Davies *et al*, supra note 5.
44 Ibid.
45 Ibid.
46 Cahn & Donald, supra note 11, p. 829.
concentrate on long-term strategic planning and supervising operations. The fifth reason relates to easier integration of acquired companies and use of the value embodied in their firm names, as well as access to foreign markets where it might be more difficult to establish and to operate through a mere branch office.47

The same factors that make a group structure attractive for a parent company can be the basis for concern to other stakeholders. While the activities of subsidiaries are conducted in the interest of the whole group, liability arising from these activities is limited to the assets of the individual subsidiary.48 For the creditors of a subsidiary this is particularly dangerous if the company is engaged in hazardous activities or is thinly capitalized and sustained by intra-group loans.49 Transfers of value from the subsidiary to its parent company or other related corporations by way of pricing arrangements for goods or services, or the taking of the subsidiary’s corporate opportunities, may be harder to detect than in a single corporation where passages to a dominant shareholder will usually be more obvious.50 For these reasons, corporate groups can present significant dangers for the creditors and minority shareholders of a subsidiary.

According to Janet, important issues arise with regard to corporate groups. Such issues include: Whether directors of a member company of a group can be justified to extend benefits including financial and non-financial benefits to the interests of the group, at the expense of their own company’s interests? Whether the controlling shareholders of the group owe a duty of good faith and fair dealing towards outside minority shareholders in the group? When will the controlling company in the group be liable for the debts of an insolvent member? Whether there should be a pooling of assets and liabilities in the liquidation of a group of companies?51

Not all states, however, take these issues as concerns of priority. In horizontal groups, which is common in the Japanese traditional Keiretsu, a complex network of small cross-shareholdings, coordination may be achieved through regular meetings of the chairpersons and by interlocking

47 Ibid, see also Davies et al, supra note 1, p. 590.
48 Ibid.
49 Ibid.
50 Ibid.
51 Janet, supra note 41, p 44.
directorships.\(^{52}\) In the *Keiretsu* system it is unusual for wholly owned subsidiaries to exist because of the system of cross-shareholdings.

Though entrepreneurial reality\(^{53}\) justifies parent company’s direction of its subsidiary, some cases of regulation may merely consider one-sided benefits such as “directions to the subsidiary to act in a way which is disadvantageous to it (and its creditors and outside shareholders) in order to benefit the parent (and its creditors and shareholders)”.\(^{54}\) It is, therefore, common for countries to regulate corporate groups to protect the minority shareholders and/or creditors of the subsidiary, its shareholders and creditors and even the minority shareholders of the parent company. Some countries regulate them using the general creditor protection rules\(^{55}\) and others develop distinct rules to mitigate the setbacks of group companies\(^{56}\).

In general, there are two approaches in this regard: the *protective approach* and the *organizational approach*.\(^{57}\) While the former, also called an ‘*entity approach*’ is based on a view of the group as a ‘risky’ institution, the latter regards corporate groups as an entrepreneurial reality, trying to provide them with safe guidelines for their operation and for the ongoing interaction between the member entities and, in particular, between their organs.\(^{58}\) The organizational approach, also called an ‘*Enterprise Theory*’ model of corporate groups, according to Philip Blumberg, gives legal form to real-world experience.\(^{59}\) Blumberg’s enterprise model counters the separate entity doctrine, “the most significant barrier to acceptance of the existence, and,

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\(^{53}\) In essence, ‘entrepreneurial reality’ in this context signifies the practical, real-world operations of businesses within a corporate group, where decisions are often made for the collective benefit, even if they challenge older, traditional business and legal concepts. See Jose Miguel (2005), “Trends and realities in the law of corporate Groups”, *European Business Organization Law Review*, Vol.6, No.1, 65-91, p.77.

\(^{54}\) Davies *et al*, *supra* note 1.

\(^{55}\) UK is an example.

\(^{56}\) The German statutory regulation of public companies provides two models of regulation, one of which is contractual and thus optional. Under the optional provision, in exchange for undertaking an obligation to indemnify the subsidiary for its annual net losses incurred during the term of the agreement, the parent acquires the right to instruct the subsidiary to act in the interests of the group rather than its own best interests. See Section 18 of German Stock Corporation Act.

\(^{57}\) Miguel, *supra* note 53, p. 81.

\(^{58}\) Ibid.

\(^{59}\) Blumberg, *supra* note 4; see also Considine, *supra* note 5, p 40.
therefore, responsibility and obligation, of corporate groups,” by ignoring it, constructing a new entity with legal consequences from the totality of the individual corporations.\textsuperscript{60}

As polar extremes, both approaches show specific features and they are based on different standards. Mere emphasis on the organizational approach will make the subsidiary irrelevant making it a mere vehicle for an act or harm that may be raised by a third party in interest.\textsuperscript{61} The protective approach has the potential to mitigate risks that may result from the primacy of the group interests by putting forward measures to protect creditors and minority shareholders in the subsidiary.\textsuperscript{62}

However, the indiscriminate application of criteria such as “‘piercing of the corporate veil’, does not suitably reflect the intrinsic complexity of corporate group interests.\textsuperscript{63} There are countries that apply enterprise theory in intra-corporate group conspiracy for purposes of the antitrust laws.\textsuperscript{64} Something in between which involves a balanced combination of regulation and autonomous will should be in order.\textsuperscript{65} This will defend corporate freedom without compromising the protection of the weakest interests thereby building a ‘serious’ public image and legitimacy and responding intrinsic complexity of corporate groups and entrepreneurial reality.\textsuperscript{66}

US Courts devise mechanisms to harmonize both interests. They allow some directive power of the parent to secure group interest at the same time making some exceptions to separate legal entity using prescriptions such as agency or the ‘utter identity and community of interests’ test.\textsuperscript{67} Other grounds such as economic integration, financial interdependence, administrative

\textsuperscript{60} Ibid, Considine, \textit{supra} note 5, p 42.
\textsuperscript{61} Ibid.
\textsuperscript{62} Miguel, \textit{supra} note 53, p. 79.
\textsuperscript{63} The traditional ‘piercing’ jurisprudence resting on the demonstration of three fundamental elements: the subsidiary's lack of independent existence; the fraudulent, inequitable, or wrongful use of the corporate form; and a causal relationship to the plaintiff's loss will not suffice in the matter of group companies. Blumberg; see also Ibid.
\textsuperscript{64} [T]he coordinated activity of a parent and its wholly owned subsidiary must be viewed as that of a single enterprise for purposes of s 1 of the Sherman Act. The European Court of Justice, in dealing with an appeal from a decision under Art 85 of the EEC Treaty dealing with ‘concerted practices’, said that the fact that the subsidiary has a distinct legal personality does not suffice to dispose of the possibility that its behaviour might be imputed to 'the parent company' Considine, \textit{supra} note 5 at 40.
\textsuperscript{65} Miguel, \textit{supra} 53, p. 81.
\textsuperscript{66} Ibid.
\textsuperscript{67} Considine, \textit{supra} note 5, p. 43.
interdependence, overlapping employment structure and a common group persona give rise for implicating liability. Thus, these courts have refused to recognize corporations that have lacked any realistic independent existence where they have no business objective, are sham or where the parent company's exercise of ‘control’ has been so intrusive making day-to-day decisions, ‘piercing’ has been approved without regard to the other elements traditionally required.

4. Regulating Group-Entity Interest Dichotomies under Ethiopian Law

This section and the next four sections (Sections 5 to 8) examine the Ethiopian legal regime in regulating group companies. The themes addressed in the sections are based on the aforementioned discussion. Ethiopia has primarily adopted the German model regarding the nature, formation, and control of Group Companies, albeit certain exceptions. Ethiopia has also integrated elements from the UK Company Act. For instance, while German law imposes the duty of due diligence and fiduciary responsibilities on the directors of the parent company, the Ethiopian Code places more stringent fiduciary duties on the directors of its subsidiaries.

Under German law, in exchange for the undertaking, an obligation to indemnify the subsidiary for its annual net losses incurred during the term of the agreement, the parent company acquires the right to instruct the subsidiary to act in the interests of the group rather than its own best interests. This may contribute to the achievement of the entrepreneurial reality by pursuing the interests of the group, “even if a particular transaction was to the disadvantage of a particular subsidiary, provided that, over time, there was a fair balance of burdens and advantages for the subsidiary.” This balances between a coherent group policy and the protection of creditors and minority shareholders in the subsidiary. However, the Code follows British law

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69 Ibid.

70 Commercial Code, supra note 18, Article 563(1).

71 Paul Davis, supra note 5

72 Ibid.
applying to the directors of a subsidiary who ought to consider whether it is in the interests of the subsidiary to follow instructions from the parent.73

4.1 Power to give instructions

While the Commercial Code’s provisions give much power to the parent company to direct and intervene in the affairs of its subsidiary, it is not clear whether these provisions involve the doctrine of “institution of hierarchy”74 vis-à-vis the liability of the parent. The controlling mechanisms that the parent company can apply show that the Code recognizes the “asset control” and “management/structural control models.”75 The Code recognizes the creation of a group on the basis of the operational structure of each corporate entity within the group and on the financial nexus between them, the level of dependency of their managements, and the degree of centralization and autonomy of decision making.76 Looking at the provisions related to the parent company’s power of direction, the Code seems to incline towards treating group companies as a single enterprise under common control.

Other than few rights of shareholders, the Code does not refer to the principles of individual companies that can be applied in the cases of corporate groups.77 If the parent has more than half of the subsidiary’s ownership of shares it can direct the subsidiary in the general meeting as a controlling shareholder. It has the right, through its board of directors or senior management, to give instructions to the organs of management of its subsidiaries.78 It is also the obligation of the management of the subsidiary – unless they are appointed by other shareholders of the subsidiary or the Memorandum of Association– to comply with the instructions forwarded by the management of the parent.

This is not by itself a problem given the necessity of entrepreneurial reality. The matter is that the parent company has a stake –greater in the operation and existence of its subsidiary– owing to the investment it assumed beyond its stake on the entire group. Therefore, application of statutory and jurisprudential single entity safeguards such as independent legal personality and limited liability –developed before the concept of group corporations was

73 See Article 563 of the Code and Section 172 of UK CA, for further discussion on director’s fiduciary duty.
74 Institution of hierarchy considers corporations as public institutions involving public interests on which the state is required to intervene. See Considine, supra note 5, p. 50.
75 See Articles 552 and 556 of the Code.
76 Considine, supra note 5 p 51; See also Janet, supra note 41, p.112.
77 See Articles 555, 559 & 562.
78 Id., Art. 556.
not yet imagined—to group companies could be problematic.\(^{79}\) This creates possibilities that the parent company gives instruction on how to perform its business for the interest of the entire group; it may also allocate new opportunities to the subsidiary and the subsidiary may fall into insolvency which the parent will be called for rescue.\(^{80}\)

Though the parent may rely on the group interest argument and the need for a strategic interest from the center, the reality, however, is that “the integrated decision-making process is not at least theoretically accepted for companies to establish their own governance structure within their geographic and business area”.\(^{81}\) In practice, parent companies’ directors formulate policies to the group allowing subsidiaries to adapt to their business.\(^{82}\) In some countries, case laws have been established to govern corporate groups. The question is whether these separate corporations truly operate as essential components of the group, or whether they function as independent businesses.\(^{83}\) In the US approach, for example, the parent company’s exercise of control over day-to-day decision-making of a subsidiary is widely believed as one form of unacceptable exercise of control that will lead to the imposition of liability (or other legal consequences) on the parent.\(^{84}\)

In bankruptcy law, in particular, there is a movement towards the recognition of enterprise liability for evaluating intra-group claims according to fiduciary standards.\(^{85}\) There are also provisions for upsetting the preferences to insiders (including related companies) and the emergence of a doctrine of substantive consolidation in which the bankruptcy proceedings of interrelated companies are consolidated and administered jointly.\(^{86}\)

Under the Code, the right to give instruction is stated without the corresponding obligation on the part of the parent. It, therefore, means that it

\(^{79}\) Blumberg, *supra* note 68, pp. 193; see also Davies *et al*, *supra* note 1.

\(^{80}\) Davies *et al*, *supra* note 1

\(^{81}\) Janet, *supra* note 41

\(^{82}\) Ibid

\(^{83}\) Blumberg, *supra* note 68 at p 193

\(^{84}\) Ibid.

\(^{85}\) Ibid.

\(^{86}\) Ibid.
is difficult to apply fiduciary standards like that of the US\textsuperscript{87} or reporting and supervisory obligations as in Germany\textsuperscript{88}.

Except in limited matters such as exploiting the business opportunity of the company or the general approval requirements by the minority shareholders in the subsidiary,\textsuperscript{89} the Code fails to state the reasons when this power of instruction will require compensation to the subsidiary or its minority shareholders or creditors. The range of such instructions can be quite open-ended, and could include orders to relinquish corporate opportunities, make discount deliveries, transfer proprietary information, and perform services without compensation.\textsuperscript{90} Another problem may arise when the parent is not subject to co-determination, while the subsidiary is; under such settings, the burdens of co-determination on the subsidiary are essentially side-stepped.\textsuperscript{91}

Even what constitutes corporate opportunity is not clear. And interventions such as the transfer of asset may also be more detrimental to outside creditors and shareholders\textsuperscript{92} as it can result in dilution of asset value for outside shareholders and increased risk for creditors, among other things. It means, therefore, directions given to the management of the subsidiary shall be fair and contribute to the interest of the minority shareholders of the subsidiary. Where the intervention inhibits this fairness principle what recourses will the minority shareholders have? Where the parent company exploits the corporate opportunity of the subsidiary and if it diverts potential profit interests of the subsidiary’s shareholders, what remedying mechanisms should the parent be subjected to? The Code is silent in this respect.\textsuperscript{93} The US corporate governance system requires a transaction between a dominant shareholder and the company be subjected, among other things, to the dominant shareholder’s

\textsuperscript{87} For example, under Delaware Common Law, both the legal representative of the parent and the directors of the subsidiary must meet the standard of care of a “prudent and reasonable manager” when performing their duties in connection with the domination agreement. Ibid.

\textsuperscript{88} The controlling person shall compensate the damage suffered by the members (partners, shareholders) of such controlled person, and it shall do so separately from the obligation (duty) to compensate detriment (damage) to the controlled person. German Code, section 66.

\textsuperscript{89} Commercial Code, supra note 18, Article 560.

\textsuperscript{90} Cahn & Donald, supra note 11, pp. 840-860.

\textsuperscript{91} Ibid


\textsuperscript{93} Detailed analysis is made below under Sections 4 to 6.
responsibility to prove the fairness of the transaction which should also fall within the range of reasonableness.\textsuperscript{94}

\textbf{4. 2 Disclosure requirements}

Under the Code, the management of the parent company should reveal the facts of control to the subsidiary so that it will be able to give directions and assume potential responsibilities.\textsuperscript{95} If control arises from an agreement between the parent and subsidiary, the requirement of notification of the same might not be applicable. However, the removal of control rights will still be required irrespective of the manner of control from either management. The parent should be notified of the rights of shareholding by the subsidiary in the former\textsuperscript{96} because the law clearly prohibits cross-ownership let alone where one of the companies—the parent—has a controlling share.

The purpose of the prohibition is clear, i.e., creditors and minority shareholders may be affected if the capital of either of the companies is affected. This sub-provision, however, seems to allow cross holdings of shares when the subsidiary is a foreign company on which a disclosure requirement is not mandatory.\textsuperscript{97} The prohibition of cross holdings will otherwise be applied for the law prohibits cross holdings above 5\% cumulative.\textsuperscript{98}

The obligation of the subsidiary to disclose its ownership in other companies, however, emanates from protecting the interest of the parent company itself. It has the right to ascertain the business and operation of the subsidiary in general. It seems, therefore, Article 554(2) has plurality of purposes and should be entertained in line with Article 555 and the following provisions regarding the rights of the parent company. These powers of the parent company to seek and obtain any information from a subsidiary is subject to the rules of incorporation of the subsidiary or interested third parties.\textsuperscript{99}

A problem may also arise, either in the ordinary course of business or as a result of questionable or illegitimate strategies, when the parent company avoids financial liabilities by relying on the separate corporate personality of

\textsuperscript{95} Commercial Code, \textit{supra} note 18, Article 554.
\textsuperscript{96} Id., Art. 554(2).
\textsuperscript{97} Ibid.
\textsuperscript{98} Id., Art. 555.
\textsuperscript{99} Id., Art. 557.
a particular subsidiary. In formal legal terms, a parent company is not generally liable for the debts of an insolvent subsidiary unless there is evidence that improper transactions or managerial decisions have been carried out with a view to shifting debts or other financial obligations onto the subsidiary and thus avoiding overall group liability. The rejection by the parent to assume the liability of the subsidiary may taint the reputation of the group as a whole. In fact, in practice, most large groups do not act in this way and will guarantee the debts of a potentially insolvent subsidiary or provide a less formal ‘letter of comfort’ to satisfy its auditors that it can be accounted for as a going concern. But where the liabilities are very large, for example, where there has been a major accident or incident causing substantial liabilities in tort, these companies may seek to rely on the separate status of the subsidiary.

In any case, this does not mean that the subsidiary cannot benefit from the goodwill opportunity of the group. Nor does the parent abstain from intervening in the business of its subsidiary. However, either case will have consequences in the interests of creditors and shareholders. Though non-appointment of directors and managers of the subsidiary by the parent allows the former to disregard the instructions of the parent, as discussed above, the leverage they are supposed to have is unquestionable given the controlling power of the parent company.

4.3 Right to squeeze out
Another right of the parent is the right to squeeze out the shareholders of the subsidiary when the parent controls more than 90% of the capital and voting shares of the subsidiary by purchasing the remaining shares from these other shareholders. The parent, however, should comply with the requirements of redemption under Article 294. It should comply with the requirement of proper notice, the price and terms of redemption and the appointment of an expert valuator. An appraisal right of shareholders of the subsidiary may be inferred from the Code’s provisions.

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101 Ibid.
102 Ibid.
103 Ibid.
104 Commercial Code, supra note 18, Article 558.
105 Id., Articles 292, 294.
5. Directors’ Fiduciary Duties and Strategic Interest

The most important issue that complicates the matter in corporate groups is the mismatch between the subsidiary company directors’ fiduciary obligations and the group’s strategic interests. The argument is that managers must focus only on the company they are serving at the moment of decision-making. The extent of the legal adaptation to reality is that the interests of the group may be of relevance in determining the interests of the company and “whether an intelligent and honest” director of the company “concerned could, in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company”.

The issue of fiduciary obligation is central, because “if a shareholder, being a parent corporation, directs the control and placement of assets, then in allowing that situation to exist, the directors must be prima facia in breach of their duties.” Even if the directions given concur with the “honest opinions of the directors of the subsidiary,” the very existence of, and acquiescence to, those directions is arguably close to a breach of duty. The justification behind this proposition is that unless the corporation, and its directors, are independent of outside influence, the theory of the corporation as a separate legal entity breaks down.

Legal prescriptions, however, do not always guarantee practical upholding. In most large multinationals, the structures for managerial decision-making are based on “functional or product divisions” (divisional approach) that are typically overlaid upon, and often cut across, the formal legal structures justified for its expedition to the coordination of different activities. But it also results in the systematic neglect or disregard of the formal rules and obligations of company law in most jurisdictions. Although this approach may be seen as lessening the centralization of group management, it is far from the practical reality of the way in which groups are managed, and it is thus of very doubtful utility.

106 Janet, supra note 41, p. 43.
107 Id., p. 44.
108 Considine, supra note 5, p. 50.
109 Ibid.
110 Ibid.
111 Hadden, supra note 94, p. 120.
112 Ibid.
113 Janet, supra note 41, p. 44.
Under the Code, the management of the subsidiary or the non-controlling shareholder of the same is required to comply with the direction power of the parent. However, they should prove the fulfillment of certain conditions in order to be relieved from liability and considered to have not acted in breach of their fiduciary duties. These conditions require proving that:

- the decision is in the interests of the group;
- the management, acting based on the information available to them and that would be available to them if they complied with their fiduciary duties before taking the decision, may reasonably assume that the damage will, within a reasonable period, be balanced by gain;
- the damage is not such as would place the continued existence of the company in jeopardy.114

The management of the subsidiary may comply, at its own risk, with instructions from the parent company if the conditions set in Sub-Article (1) are not satisfied.115 This provision seems to add to the managerial autonomy of the company despite uncertain execution given the alignment of interests between the parent and directors appointed by it in practice. Another concern is that directors of the subsidiary are exposed to serve multiple principals since the Code recognizes and even obliges these directors to receive and honor directions from the parent company.

But who will have a dominant power of approval and renunciation in the subsidiary in the face of a controlling parent shareholder? What constitutes approval and how should it be counted? All these are not clear from the Code. Article 556(3) of the Code is not clear as to what “… not bound by the instruction of the parent” means. Nor is this issue addressed under Article 563. Moreover, a problem may arise where the sacrifice of the opportunity affects creditors of the subsidiary since the Code simply focuses on the continued existence of the company than the creditworthiness of the company.

This provision can be a ground for disregarding the corporate veil of the subsidiary company though the process of making it effective seems unlikely since the affected parties (minority shareholders and creditors of the subsidiary) do not have a mechanism of recourse. Moreover, the parameters for considering the decision to be “in the interest of the whole” are not clear whether due consideration is given to those parties likely to be affected. With the lack of practice in piercing the corporate veil in Ethiopia, such a legal gap will eventually harm creditors and shareholders alike.

114 Commercial Code, supra note 18, Article 556.
115 Id., Article 563.
Moreover, the parent company does not have a mandatory rescue obligation if the subsidiary falls into insolvency whether or not the insolvency results from a wrongful trading or exploitation of the corporate opportunity of the subsidiary by the parent. A subsidiary company managed according to instructions issued by its parent—even in the interest of the group—can only be subject to fundamental restructuring or winding up procedure which shall be initiated by the latter. The parent will only be liable to third parties for the debts of the subsidiary incurred after such crisis point or if the debts resulted from the harmful instructions to which the liquidators or the trustees of the subsidiaries will invoke.

Under the German system, when the parent company issues binding instructions to the directors of the controlled company, it will in return be required to compensate the controlled company for any loss as a result of its control and also to pay a fair dividend to minority shareholders or to buy them out at a fair price. Unlike German law, the Code entitles creditors holding not less than 10% of the debts of the subsidiary to request the liquidator or trustee to exercise the right to redress on behalf of the claimants with regard to any unpaid debts.

Chances may be that the administrative interdependence will inhibit the obligation of the subsidiary company’s directors towards the company which appointed them. This should entail the potential to hold the parent and its directors liable by and large as the subsidiary’s directors where the interference becomes damaging to minority shareholders and creditors. Moreover, the subsidiary directors face an elevated burden of responsibility due to this interference, even when the outcome is detrimental to the subsidiary's ongoing viability. It should be noted that, this does not automatically obligate the parent company to intervene for the subsidiary's rescue.

The fate of dissolution cannot be mitigated except with the possibility of reorganization and preventive restructuring with the consent of the creditors. The parent company will be liable for unpaid debts of its subsidiary if it has managed the latter to its detriment and in violation of the interest of the group.

116 Commercial Code, supra note 18, Art. 564.
117 Hadden, supra note 96, p.120.
118 Commercial Code, supra note 18, Art. 564.
119 Id., see articles 558 ff.
120 Id., Art. 564(3).
It seems that in the former case a justification for group interest is acceptable unless the parent company fails to take immediate measures of restructuring or liquidation. The burden is, therefore, imposed on the directors of the subsidiary company to take great care of their company’s and creditors’ interest. The reality, however, may be different on the ground that the parent backed by legal protections may abuse its rights and power. It may also encourage companies to involve in businesses that are bogus, exploiting the interests of the subsidiary and its stakeholders. In the US system, principles of agency law are applied to justify piercing the liability of the parent by disregarding the corporate entity; this applies when “dominion is so complete and interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent”.  

6. Group Interest versus Minority Shareholders Protection

Where subsidiaries are partly owned, the important issue of minority shareholder protection will arise. The general rules on minority shareholder protection are insufficient if a controlling shareholder has substantial business interests besides the stake in the controlled corporation for two reasons: first, the controlling shareholder may have the incentive to damage the corporation for the sake of promoting these other business interests, and second, because it may be difficult to detect whether the controlled corporation has in fact been damaged if it is engaged in business with other companies dominated by the controlling shareholder.  

Victims can be minority shareholders of either the subsidiary or the parent though the former are more vulnerable. According to Cox & Eisenberg, parent corporation’s minority shareholders will also be affected, when their veto rights with respect to “corporate actions requiring supermajority approval can effectively be undermined by setting up a holding structure where the assets are owned and the business activities are conducted by subsidiaries while the parent corporation merely acts as a holding company.” The parent’s voting rights in the subsidiaries are exercised by, or under the direction of, the parent’s directors usually elected by no more than a simple majority of the votes where a majority shareholder has leverage to control. Thus, by virtue of its influence over the parent’s management, a dominant shareholder of the parent company can control decisions on matters in subsidiary corporations.

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121 Blumberg, supra note 68 p. 192
122 Cahn & Donald, supra note 11, p. 850
123 Cox & Eisenberg, supra note 52.
124 Cahn & Donald, supra note 11 p. 853.
that could have in many circumstances been vetoed by the parent’s minority had the assets remained at the parent level.  

Under German law, where shareholders decide on the distribution of profits, this right will be exercised by the parent’s management if the business is conducted and the profits are earned by a subsidiary, rather than by the parent itself. Retention of profits in the subsidiary can be used to starve out the parent’s minority shareholders; absent a dominant shareholder, the parent’s management could also use it to control the group’s internal financing. These dominant shareholders with effective control over the management are known as “shadow directors” under English Law.

Under the Code, the shareholders of the parent have the right to information and the right to request a special investigation. In particular, they have the right to appoint one or more inspectors to investigate; the right to inspect and take copies of documents of the balance sheets, profit and loss accounts and inventories; reports, minutes, resolutions, executive pay and register of shareholders. However, the problem is severe for the shareholders of the subsidiary.

One mechanism that these minority shareholders can secure their interests is through approval rights, with interested shareholders excluded. In some other jurisdictions shareholders may be given the right to vote for the directors of their choice, and still, in other jurisdictions controlling shareholders have a fiduciary duty to other shareholders. Under Ethiopian law, when the parent company tries to exploit the corporate opportunity of a subsidiary, these shareholders have the right to approve. The directors of the subsidiary have also such right.

Shareholders of the subsidiary that hold voting shares that represent ten percent of the capital have the right of investigation like the shareholders of the parent company. Therefore, if they believe that acts prejudicial to their interests are committed by the parent, they have the right to inform the

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125 Ibid.
126 Ibid, see also German Stock Corporation Act section 60
127 Cahn & Donald, supra note 11 p. 853.
128 See section 251 of the UK Company’s Act (2006).
129 See Articles 559 cum. 355, 358, 381, 382
131 Ibid.
132 Commercial Code, supra note 18, Article 563.
Ministry of Trade and Industry (the current Ministry of Trade and Regional Integration) to appoint inspectors to investigate the affairs of the company.\textsuperscript{133} This enables these shareholders to challenge the resolutions, such as transactions or re-investment that may be prejudicial to their interest, in the parent company.

The problem, however, arises when these resolutions are to the interest of the group, particularly, of the parent but disadvantageous to these shareholders. In weighing the interests various issues would arise: What parameters will the court employ? What payoffs will these shareholders receive in return? The law is not clear. The matter gets more complex since Article 358 makes reference to holding companies –not parent companies which still can be considered as different.

In the German Code, when such instruction is detrimental to the subsidiary, the controlling person shall compensate the damage (detriment) –that arises therefrom– to the controlled person and shareholders separately.\textsuperscript{134} The members of the management of the parent will be severally and jointly liable for discharging the obligation to settle.\textsuperscript{135} Unlike German law, the Ethiopian Commercial Code articulates the obligation to compensate the subsidiary or its creditors narrowly that are applicable to debts that occur as the consequence of the instruction.\textsuperscript{136}

The issue that needs attention is whether provisions such as Article 364 –that prohibit the general meeting to pass a resolution and that may have a clear effect of giving undue benefit to some shareholders– can be applied. This is because the wronged shareholders in the present case are shareholders of the subsidiary, not the parent which could have raised such issue to challenge the resolutions according to Article 391(2).

Yet one can argue that the resolution of the subsidiary based on the instruction given by the parent can be challenged by the same shareholders. The problem is that the Code gives intense power to the parent company and the latter has a majority shareholding in the subsidiary. The subsidiary is, for all practical purposes, a company to which the rules of Share Company and PLC will be applied. However, not all rules are applicable to such a company given the special nature of the parent-subsidiary relationship.

\textsuperscript{133} Id., Articles, 561, 559, 355 and 358.
\textsuperscript{134} German Stock Corporation act section 317.
\textsuperscript{135} Ibid.
\textsuperscript{136} Commercial Code, \textit{supra} note 18, Article 564.
Still, arguments can be raised invoking Article 395 of the Code on conflict of interest and related party transactions. Such transactions can shift resources from the subsidiary to the parent company which is detrimental to the interests of the minority shareholders and creditors of the subsidiary. Such transactions can be abused by insiders such as executives and controlling shareholders. These acts directly override the capital maintenance rules that are otherwise applicable to the transferring company.

Under German Law, minority shareholders and creditors can depend on at least three safeguards: First, the parent must compensate the subsidiary for all losses incurred during the duration of the agreement (if influence resulted from the contract), regardless of their cause. Secondly, the minority shareholders of the subsidiary may demand to either receive a guaranteed dividend or to be bought out by the parent at a fair price. Third, the creditors of the subsidiary can demand the posting of security for outstanding debts upon the termination of the agreement. Other remedies include compensations, appraisal remedies or treating the enterprise as a single entity.

In Germany, “enterprise” is considered as “any entity engaged in commercial activities of a dimension making it reasonable to suspect that the entity might promote these other activities at the expense of the controlled corporation”. The practical effect of these provisions is to consider the group and its directors as a single entity and serve within it, as well as to provide specific safeguards to protect the most vulnerable constituencies in this arrangement. Moreover, the US Model Business Corporation Act (MBCA) extends appraisal rights to minority shareholders where transactions with interested parties/conflict of interest transactions are conducted.

Under the Commercial Code, shareholders of a subsidiary can request the parent company –holding more than 90% of the shares holding votes– to buy their holdings i.e. sell out rights. Moreover, under a transaction of a material nature, the requirements of board approval, examination by an impartial auditor and shareholder approval may be applied. Therefore, these rules on

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137 OECD, supra note 130, p. 11.
138 Cahn & Donald, supra note 11, p. 854.
139 Ibid.
140 German Stock Corporation Act section 18 cum 291, 319.
141 Cahn & Donald, supra note 11 p. 853.
143 Commercial Code, supra note 18, Article 562 cum 292
144 Id., Articles 306, 307. The provisions deal with holding companies.
the approval and examination of related party transactions may assist shareholders to secure their interests. The protection under German law is clearly stronger because some rules are available for these shareholders such as rules on disclosure of inside information or publicly announcing information necessary to assess a material related transaction’s fairness, the identity of the related party and its relation to the company no later than the time of the conclusion of such transaction. If the law allows a shareholder who is a related party to take part in an approving vote, safeguards must exist to prevent the related party from causing approval against the opinion of the majority of unrelated shareholders or independent directors.

Another concern can be when the parent company commits to offset its profits against losses of the subsidiary or divert all or part of the profit of the subsidiary into the coffers of the parent and vice versa, thereby adversely affecting minority shareholders. Such agreements are frequently entered into as a prerequisite for taxation of the parties on a consolidated basis. However, such agreements should be approved by a 75 percent majority of the votes cast by the dominated or profit-transferring company’s shareholders.

An interesting query is whether the parent company, a controlling shareholder in the subsidiary, should be subject to liability as per Article 295 of the Code when it is found abusing its controlling power in the company. If it is so, why did the Code in its group company-related rules fail to refer as it did to some of the provisions (Article 358, 355…)? Even if it failed to do so, does the nature of group companies in Ethiopia and the purpose for their legal recognition and protection require otherwise? Article 295 renders the controlling shareholder and the company jointly and severally liable when the former is found to have committed:

- an unlawful act that jeopardizes the interests of the company, shareholders or creditors of the company;
- intermingles the property of the company with that of the shareholder;

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145 Cahn & Donald, supra note 11, p. 852.
146 Ibid.
147 Ibid.
148 Ibid.
149 Ibid. Moreover, under German Law, prior to the shareholder vote, the Vorstand must prepare a report on the contents of the agreement, focusing particularly –in the case of a profit transfer agreement– on the amount of compensation to be given for profits diverted. Unless the subsidiary is wholly owned, enterprise agreements must be examined by auditors and should be entered into commercial register.
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- blurs the distinction between the identity of the company and that of the shareholder or uses the company as a façade to pursue his own interests and goals or those of third parties;
- deliberately releases, regarding the financial status of the company, information that can mislead the creditors of the company;
- makes use of the assets of the company for himself or the benefit of a third party without making an arm’s length payment or without the knowledge or decision of an appropriate management body and
- causes the payment of dividends in excess of that permitted under the law.

Within the ambit of single-entity corporations, it is discernible by looking at this article that the Code recognizes the obligation of shadow directors. The problem, however, is that the burden to prove the commission of the above acts is not clear. Nor is it quite clear whether this provision is relevant in the case of group companies. Can shareholders who are entitled to request information and special investigation as per Article 559 cum 355, 358 and 381 require the court to hold the controlling shareholder/the parent company liable? What matters can be covered by this special investigation? The documents that can be inspected are listed under Article 381 including resolutions, minutes, financial statements, register of affiliated persons and reports of directors and auditors. These documents can lead these shareholders to ascertain whether one of the acts listed above is committed or not. However, Article 355 presupposes the liability of the management arising out of acts that jeopardize the interests of minority shareholders. It is plausible if the management is found to be liable for its unlawful acts in the interest of the controlling shareholder by which the former is made an agent to the latter.

However, the most common problems will be when the acts that give rise to the disadvantage of the minority shareholders appear under Articles 306, 328, 382, 394, and 395 where the minority shareholders are either empowered to prove the liability of the directors or request an ex-ante safeguard which at last will be subject to approval by the general meeting of shareholders. Though the Code fails to refer to single entity principles as listed above, the law can be interpreted in a way that entitles minority shareholders of the subsidiary to challenge the controlling shareholder under Article 295.

Moreover, the minority shareholder protection under Article 361 will also entitle such vulnerable shareholders to challenge resolutions of general meetings which obviously will reflect the interest of the majority vote holder, the parent in this case. Taking cognizant of the Code’s treatment of the holding company and parent company interchangeably, applying the safeguarding mechanisms stipulated under the provisions that state the holding company’s
obligations will be pivotal. Considering the subsidiary as either a Share Company or PLC, the specific protections extended to minority shareholders and accompanying obligations imposed on shadow directors such as under Article 295 contribute to the alleviation of potential problems peculiar to minority shareholders of the subsidiary. Such a nuanced interpretation will enable the minority shareholders of the subsidiary to exercise some important safeguards. These safeguards that can be broadly classified into derivative rights and inherent rights are briefly discussed in the following section.

7. Derivative and Inherent Rights of Shareholders

7.1 Derivative rights
Shareholders of the subsidiary can exercise derivative rights to challenge a related party transaction between the parent and subsidiary company on the ground of serious damage to the latter or fraud. Similar to the German Law, this transaction should be first approved by the directors of the concerned company. Article 306(4) prohibits the directors having a conflict of interest from voting regarding the approval of the transaction. Which directors are these? What about the directors appointed by the parent company or even the parent company itself as a controlling shareholder?

It is a fundamental principle that no one shall be a judge in his/her own case, and it can be argued that a shareholder or a director whose transaction has brought about a conflict of interest should not vote on the approval or rejection of the transaction. In fact, the fraudster party, and members of the board of directors who knew or should have known the commission of the fraud or the fact that the dealings would cause serious damage to the company shall be jointly and severally liable for damages incurred by the company as a result of the dealings.

The related parties are listed under Article 306(6) and include directors, auditors, and shareholders who have purchased at least ten percent of the shares of the company and holding or subsidiary to the company concerned. This derivative right is also recognized under Article 328(3) where shareholders representing ten percent of the capital can bring an action against a party (which may include director/s) whose default causes damage to the company within three months from the time when the company should have

\[150\] For example, rights under Articles 306, 307, 328, 357, 358, 361, 382, 385, 391, 395 and Articles referred under Article 559.

\[151\] Ibid, Article 306.

\[152\] Ibid.
brought a case. An important clause is that despite the company’s initiative to discontinue the proceeding against the responsible directors, the minority shareholders holding ten percent of the capital have the right to oppose the adoption of the resolution.  

Minority shareholders are also entitled to request information from their company or its parent company where they believe that damage to the subsidiary has occurred; or they may propose an appointment of a special investigator. Where the ordinary general meeting has rejected the proposal, shareholders representing one-tenth of the capital of the company may apply to the court which shall order such appointment or require an explanation.

### 7.2 Inherent shareholder rights

Minority shareholders can exercise rights on their own behalf and interest against the parent company, its directors or a sham or façade subsidiary. Beyond what they can exercise, the rights specified under Articles 559 cum 355 and 381, cause for inspectors to be appointed and investigate the misdeeds of directors, controlling shareholders or other related parties. The court or another relevant authority can also appoint inspectors to conduct an investigation where it has good reason to believe that the operations of the company, inter alia, reveal: (1) fraud committed or likely to be committed on creditors of the company; (2) acts prejudicial to the rights of certain shareholders; (3) illegal or fraudulent activities; or (4) acts which constitute a criminal offense.

The parent company as a shareholder or even a director acting on his own behalf or on behalf of a third party may not – in matters that involve direct or indirect conflict with the interest of the company – vote on resolutions relating to their duties, liabilities and conflict between the interest of the company and their own interest. In particular, a director or any other person, who stands to benefit from an agreement involving a conflict of interest with the company, may not vote at the general meeting considering the approval of such agreement, even if he happens to be a shareholder. In such a case where the agreement related to a transaction with affiliated persons is

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153 Id., Article 328(6)
154 Id., Article 382(2)
155 Id., Article 396.
156 Ibid.
157 Id., Article 357.
158 Id., Article 385.
159 Id., Article 395.
concerned, the subsidiary company itself, shareholders and even creditors can apply for invalidation of the agreement. This also applies when the resolution of the general meeting is contrary to law or the Memorandum of Association. Any interested party whose interest is jeopardized by a resolution adopted may apply to a court to set aside such resolution within ninety consecutive days from the date s/he knew of the adoption of the resolution.\textsuperscript{160}

\section*{8. Subsidiary Insolvency and Creditors’ Protection}

The parent company has, among other things, the right to give instruction to the subsidiary, shift assets and/or exploit its corporate opportunity. These acts can affect the subsidiary and even expose it to insolvency. While activities of subsidiaries are conducted in the interest of the whole group, liability arising from these activities is limited to the assets of the individual subsidiary.\textsuperscript{161} The Code does not impose mandatory rescue obligation on the parent\textsuperscript{162}. This will affect the interests of creditors and minority shareholders alike.

Moreover, unlike the experiences in other countries, the Code does not enable the application of the principle of corporate veil except where the subsidiary company, which has been managed according to instructions issued by its parent shall hold the latter liable for any unpaid debts of the subsidiary incurred after the said crisis point.\textsuperscript{163} However, if the parent company acts without delay for the restructuring or liquidation process of the subsidiary, it will not be liable even to creditors. This is problematic given the reason for the loss to the creditors emanates from the intervention of the parent in the affairs of the subsidiary even if it did it in the interest of the group.

The only possibility that the court can pierce the veil for the creditor’s interest is when the parent company has managed the subsidiary to the detriment of the subsidiary and in violation of the interest of the group where it shall be held liable for any unpaid debts of the subsidiary which are the consequences of the harmful instructions.\textsuperscript{164} The Code is not, however, clear whether a parent company’s acts or the subsidiary company’s obedience to the instructions of the former can raise grounds for treatment as “alter ego, piercing the corporate veil, single business entity or agency to make it liable to the debts of the subsidiary” which are common law rules in the US and UK jurisdictions so that courts can enforce mandatory shareholder/director rules.

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\textsuperscript{160} Id., Article 391(2).
\textsuperscript{161} Cahn & Donald, supra note 11, p 850.
\textsuperscript{162} Articles 560 and 564.
\textsuperscript{163} Id., Article 564(2).
\textsuperscript{164} Article 564(3).
\end{flushright}
to be observed in group companies. These principles generally apply if the parent has disregarded corporate formalities or, has actively participated in or exercised control over, the subsidiary's operations so that the subsidiary is effectively a mere instrument of its parent.

Similar to the ‘alter ego’ and ‘piercing of the corporate veil’ doctrines, substantive consolidation permits the court to disregard the separate nature of two or more corporate entities by allowing the bankruptcy court to permit the assets and liabilities of affiliated debtors to be treated as a single pool. Some countries follow the facts of unconscionable abuse of legal personality, employees’ protection, tax liabilities, intervention in the existence of a company and intentional tort acts (public policy) grounds to disregard the parent company’s defense of entity doctrine.

Jurisdictions such as UK, Germany and Canada justify piercing the corporate veil of the parent company to secure the liabilities of its subsidiary when certain contractual terms are violated. Under English law, a parent entity (domestic or foreign) of a limited company cannot be held liable for the debts of that subsidiary upon its insolvency unless it has contractually agreed to accept liability.

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166 Ibid.

167 Ibid.

168 In South Africa, if the court finds that the incorporation, use of, or any act by or on behalf of the insolvent subsidiary constitutes an unconscionable abuse of the juristic personality of the company as a separate entity, it can declare that the company will be deemed not to be a juristic person in respect of any right, liability or obligation of the company or of a shareholder. Lyndon Norley et al (2022), Adam Harris, Juliette de Hutton, Aanisah Ramroop, Daisy Fakude, *Insolvency in south Africa*, Thomson Reuters, at 21.


170 Under tax legislation, it is also possible for the parent to become liable for the insolvent subsidiary's tax liabilities if the parent company has received assets from the subsidiary for less than the fair market value. Ibid, p.18.

171 In Germany, anyone, including a shareholder and a parent entity, can be liable for intentional damage contrary to public policy. Anyone (including a shareholder) is, for example, liable for interventions jeopardizing the existence of the company. Georg Streit et al (2022), *Restructuring and Insolvency in Germany: Overview*, Thomson Reuters, at 18.

In Ethiopia, there is no clear law in this respect. One can reason that since a contractual agreement has been adopted as a ground for control the mere fact of agreement between the parent company and its subsidiary can include acceptance of liability by the former upon the subsidiary’s insolvency. In Germany, suretyship, guarantee, ‘hard’ letter of comfort, intercompany domination and/or profit and loss transfer agreements or other contractual obligation are grounds for disregarding the corporate veil of the parent company during insolvency.

An immense power bestowed on the parent company regarding control and direction of its subsidiary with little safeguards for creditors and minority shareholders becomes detrimental to and can aggravate the insolvency of the subsidiary. This emboldens, according to, Lord Walker, “risk-averse individuals to use artificial corporate structures in order to insulate themselves against the responsibility to an insolvent company’s unsecured creditors”.

As discussed above, the application of Article 295 in the case of group companies can alleviate such legal loopholes. The provision can be invoked especially when the parent shareholder engages in an unlawful act –that jeopardizes the interests of the subsidiary and its creditors of the company and/or blurs the distinction between the identity of the company and itself, or uses the company as a façade to pursue his own interests and goals or those of the third parties. Under such situations, applying the principle of piercing the corporate veil will alleviate the problem and parallel Ethiopia with other countries.

9. Conclusion

Entities within a corporate group are commonly referred to as parent-subsidiary or holding-subsidiary entities across various jurisdictions. The Ethiopian Commercial Code (2021), much like the German Law, delineates specific regulations for the governance of these group entities, encompassing both domestic and foreign subsidiaries. However, the Code falls short of the standards set by the German Stock Corporations Act and comparable regulations in other nations. It does not establish sufficient protective measures for subsidiaries and their stakeholders.

173 The Code recognizes contract as a ground of control the subsidiary. See Article 552(2) & (3)(b).
174 Georg Streit supra note 171 at 18.
175 Cahn & Donald supra note 11, at 850.
176 Article 295(1) & (3).
Although certain provisions within the Code draw from the regulatory framework for single-entity companies to safeguard the interests of minority shareholders in subsidiaries, it overlooks key principles of creditor protection and minority shareholders' rights. Furthermore, the Code does not sufficiently address challenges pertaining to aligning the fiduciary responsibilities of subsidiary directors with overarching group strategy, balancing group interests against those of minority shareholders, and managing conflicts between subsidiary insolvency and creditor rights.

The Code seems to prioritize the unique characteristics of group companies by establishing specific rules for them. This limits the applicability of single entity company regulations, restricting its relevance to only a select few provisions of the latter, potentially jeopardizing the rights of more vulnerable stakeholders. Such an oversight may compromise the integral interests of subsidiaries, their minority shareholders, and creditors, which could have otherwise been fortified through the wider application of general corporate governance principles. To rectify these shortcomings, a more expansive interpretation of the rules that govern corporate groups is recommended, coupled with a broader application of single-entity company provisions. Such an approach would significantly enhance the derivative and inherent rights of shareholders.
Cited References


