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AFFILIATE COMPANIES IN ETHIOPIA: ANALYSIS OF ORGANIZATION, LEGAL FRAME WORK AND THE CURRENT PRACTICE

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Declaration

The thesis is my original work, has not been submitted for a degree in any other University and that all materials used have been duly acknowledged.

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Abstract

The formation and of operation of affiliate companies have become an enterperunreial reality in contemporary society. These companies have the freedom to determine the size and boundary of their organization , and in so doing they limit (and some time evade) their legal duties since they are characterized by their unity as commercial enterprise and their legal diversity (multiplicity) and legal segregation and insulation and member companies .Such a gap between organizational and legal structure in the realm of affiliate companies have been the subject of many academic discussion and there are also judicial and legislative development in the area, a tendency for special regulation in the interest of minority shareholders and creditors of the member company in the group particularly in the civil Law legal system. The paper endeavors to investigate the organizational structure of officiate company in Ethiopia and analyzed with the rules on joint holding, limitation on acquisition of bank shares, rules on liability of directors officers and managers and consolidation in bankruptcy. Apart from the absence of special regime and the insufficiency in the existing legal rules; courts, practitioners and regulators are not familiar with the legal consequences of opera ting affiliate company. So to curb problems presented to interests allied with affiliate company organizational structure such as creditors; judicial actions under the existing legal framework and legislative reform of the subject under consideration is recommended.

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Chapter One
Introduction

1. Background

Affiliation among companies is by no means a recent (a late 20th century) legal phenomenon, rather it has long been a reality through out the world. The emergence of affiliate companies is attributable to the legal invention of the doctrine of corporate personality as revealed by the experience of Anglo-American legal families[1] discussed below. That is because companies have legal personality they can be shareholders of other companies leading to formation of groups. Thus, separate legal existence of companies had helped business owners to structure their enterprise in the form of more than one company.

In Britain company groups emerged after the power of companies to own share in another company was accepted in mid 19th century; and the emergence of corporate groups in the United States commenced with a liberalization of state corporation law that permitted inter-corporate stock ownership for the first time, i.e. corporation itself, not only natural person investors were allowed to acquire and own the shares of (other) corporations, where New Jersey blazed the trial in 1883 and eventually all other states followed the suit.[2] Though their origin lie far back in the 19th century, their emergence as a prevalent form of industrial organization in modern market economies only occurred during the second half of the twentieth century.

That is, following the Second World War the world witnessed an explosive proliferation of corporate groups both nationally and internationally.[3] First, in America, affiliate group of companies existed over the course of 20th century predominantly in diversified organizational forms.[4]

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1 Muscat Andrew, The Liability of the holding company for the debts its insolvent subsidiaries, Dart Mouth Publishing Co. Ltd, England, 1996 P. 1

2 Ibid.

3 Ibid. P. 2

4 Fligstein Neil and Freeland Robert, "Theoretical and comparative perspectives on corporate organizations," in Annual Review of Sociology Vol. 21 1995 P. 35

Second, in France and Germany as a result of their industrial policy, in addition to government control of large number of large firms or substantial ownership stakes in important industrial firms, private firms in these countries are organized in such a way that enables to create economies of scale and to cooperate when their products are intended for export.[5]

Third, in Japan, their core industrial economy is organized into enterprise groups known as *keirestu* which are of two kinds: bank centered groups and groups formed of subcontract relationships.[6] In the first type of groups, there are large number of industries and at the center of the group is often a bank, where as in the latter group parent-subsidiary relationships are common.[7] Like in Germany, Japanese government played active role in investment pattern in the economy in that, firms were encouraged to enter export markets through credit allocation to projects that would produce goods for export and by reinforcing the *keiretsu* organizations.[8] Finally, the emerging capitalist countries of Asia such as Taiwan, South Korea and India are also dominated by corporate grouping structure.[9]

So, one can say business groups nowadays dominate private sector activity in most developed and emerging markets of the world. Not only the domestic arena but also the entire globe is replete with immensely powerful group operations.[10] As a result, the business enterprise in contemporary society is no longer the 'single company' organization, rather the complex corporate group composed of interrelated but legally separate corporate components that are operating in large medium sized and smaller enterprise businesses.[11]

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[5] Ibid. P. 37

[6] Linclon James and McBride Kerry, "Japanese Industrial organization in comparative perspective," in Annual Review of Sociology 1987 Vol. 13 P. 306

[7] Supra note 4 at 38

[8] Ibid.

[9] Ibid, Khanna Tarun and Palepu Krishna, "Is Group Affiliation Profitable in emerging markets? An analysis of diversified Indian Business groups" in The Journal of Finance 2000 Vol. LV. No. 2 P. 867

[10] Supra note 1 at 4

[11] Ibid. P. 3

Such tendency of organization to grow and expand from time to time both nationally and internationally, not only as single unit but also in to a number of related legally separate firms is not matched by parallel development in the existing legal framework. In other words even though corporate groups have been a familiar feature of economic life for a number of decades, the law generally remains oblivious to the group phenomenon.[12]

Moreover affiliate companies may be established for the purpose of limited liability of one company when it wants to engage in excessively risky activity. "If limited liability is absolute, a parent can form a subsidiary with minimum capitalization for the purpose of engaging in risky activity. If things go well the parent captures benefits. If things go poorly, the subsidiary declares bankruptcy, and the parent creates another with the same managers to engage in the same activity".[13]

Further, affiliated group of companies as an organizational form raises a number of legal issues in areas of competition policy and regulation, taxation, company law, bankruptcy law, financial market law, labour law and so on. There are various interests in a group structure that lead to such legal problems. These include the interest of the enterprise as an economic unit, the interest of individual companies in the group, the shareholders, financial investors, creditors, the government and the public at large.[14] Though these interests are not different from those that would be asserted in one company model, the group structure and group method of doing business exert additional pressure on various interest of the stakeholders as could be explained in different branches of law:[15]

In area of competition policy and regulation, the formation of corporate grouping, may create market concentration or dominance by such firms though that may be helpful for developing countries for firms to attain economies of scale, to enter export market or compete with foreign firms. With respect to taxation, the problem of group structure is

[12] Ibid. P. 27
[13] Easterbrook H. Frank and Fischel R. Daniel, "Limited Liability and the Corporation" in University of Chicago Law Review. 1985, Vol. 52, No. 1 P. 111
[14] Supra note 1 at 25
[15] Ibid.

that, companies may attempt to manipulate their inter-corporate dealings to gain benefits beyond those envisaged by legislation. [16] Financial market laws are interested in regulating the extent of affiliation financial companies could have with each other or non financial firms, the transaction entered in to and investments made by financial companies with respect to affiliate companies in the interest of the public, government and creditors. In company and bankruptcy law area, ordinarily the legal scheme relates to protecting the interest of company, minority shareholder and creditors. But as corporations starts to take affiliate structure the legal rules routed in the traditional entity law doctrine does not give sufficient protection to them.[17]

The problem of complex corporate systems had out stripped traditional corporate law. So, it is argued, as company system and affiliation appear and grow in size, there is a need to supplement traditional theory of corporate personality by a new theory emphasizing enterprise over entity known as theory of corporate enterprise.[18] So, nowadays countries are trying to address the peculiar problems of affiliate companies through legislations either as part of company law or particularly relating to affiliate companies or through judicial practice.

In Ethiopia too, it is felt that affiliation among companies is emerging in the country whereas the Commercial Code lacks sufficient framework for the regulation of such companies; "Hence, in view of the increase in the interests of holding companies, as we have them in MIDROC Ethiopia and some other big businesses revision of the Commercial Code to fill in the current lacuna is on the order of the day."[19]

2. Statement of the problem

Affiliate companies are in the commercial scene in number of countries of the world for over a century. As an organizational form, it is at odd with traditional corporate law

[16] Ibid.
[17] Ibid. PP. 17-18
[18] Blumberg Phillip I. "The Corporate Personality in American Law: A summary Review" in American Journal of Comparative Law Vol. 38 No. 1 P. 52
[19] Tilahun Teshome, Some Notes on Ethiopian Commercial Law, Tiret - The MIDROC Ethiopia Group Magazine, Vol. 5 No. 2 2001 at 49

originating in 19th century to govern one company or single company model. As a result, the power and complexities of corporate grouping structure in business in relation to various interests involved has attracted the attention of many academics, law makers and judiciary in various countries.

In Ethiopia too, as part of global economy and as a result of the country's economic policy the past nearly two decades has witnessed the formation of affiliate companies in both financial and non financial private sector of the economy. Where as, the existing legal framework governing company is not adequate to regulate such emerging corporate grouping structure in the country.

"Affiliation between companies assuming such designation as business groups or conglomerates . . . may have serious repercussions on the right of creditors as well as minority shareholders. In view of this, we have identified it as an area of major importance that needs to be further studied and regulated."[20]

The following particular problems are the subject of inquiry in the study. First, the inadequacy of the legal framework from the perspective of Ethiopian company law and/or other branch of law on the one hand, and the increasing number and proliferation of companies affiliate structure on the other is considered as one of the main problem in the study.

Secondly, the reality with respect to affiliate company organization particularly the type of organizational form and the basis of affiliation i.e. whether it is share ownership, or common business ownership or common management or contract or other source of control that ties together the member companies of the group; the type of member company in the group whether it is private or public company i.e. the ownership and control pattern in affiliate company organization. If the member companies are private limited company which is particularly the case in non-financial affiliate companies, the

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[20] ____________ Position of the business community on the Revision of the commercial code of Ethiopia, prepared by a team of fourteen national experts, (AACCSA, Sida 2009) P. 22

extent of the problem will be different from if the member companies are publicly owned, for private companies are generally not the subject of detailed regulation as compared to public companies and there will be likely abuse if the affiliate companies are in the form of private limited companies than if the member company is large and publicly owned. So, it is imperative to investigate and identify the type of companies existing in affiliation in the Ethiopian context.

Thirdly, from the previous observation of the writer and interviews conducted with the concerned officials at the Ministry of Trade and Industry, National Bank of Ethiopia, corporate directors, officers, judges and practitioners in the area, affiliated group of companies are not officially known and recognized, what is always registered is individual companies and there is no registration of more than one company as constituting a certain group.

Finally, the extent of the gap between the existing legal structure and the structure of affiliate company organization is to be investigated. In this light, does Ethiopia really need to have special regime governing affiliate companies or is there any thing the court can do under the existing legal framework when specific case involving the relationship between two or more companies constituting a group arises? What can we learn from the experience of other countries which influenced the Ethiopian company law? In this regard, on the one hand, there are problems observed in practice with respect to company affiliation like individuals sometimes establish more than one companies in the form of private limited company abusing the benefit of limited liability and corporate entity. On the other hand, apart from the inadequacy of the law in the area, the concept of affiliated group of companies and its legal significance is not well known to government officials concerned and as well to the judiciary.

3. Objective of the Study

The formation and operation of companies having affiliation among each other is an emerging business phenomenon in present day Ethiopia. This form of organization presents special problem to those who are direct or indirect stake the group.

In Ethiopia, in spite of emerging affiliate company organizational form with such group related problems, the concept of affiliate company and the legal consequence of operating such a business is not well known to the regulators, judges and the practicing lawyers as well to the business community. So it is the objective of this writer to:

- investigate the nature and organizational structure of affiliate companies existing in Ethiopia
- study the place of affiliate companies under Ethiopia legal system
- examine the adequacy of the existing legal framework (if any) in the regulation of affiliate company and suggest some way out in the form of practice (what the court and practitioners do) and possible adjustment in the legislation. In particular, assessing the risk to creditors in affiliate company situation and finding out possible legal remedy under existing law, and suggesting directions for revision of the law in pursuit of better protection for all stakeholders.

4. Scope

The scope of the study is designed as follows, first, in sample selection the study focused only on companies registered at the Ministry of Trade and Industry and those financial companies regulated under National Bank of Ethiopia.

Second, the problems that could be presented by affiliate company structure are so many and diverse as to touch many branches of law: the problem of multinationals operating through the formation corporate grouping structure, the tax effect of affiliate company and aspect of group phenomena that could present itself as problem in the area of competition law and policy. Even though these are important areas to be addressed in the study, to limit the scope of the research, discussion is made on affiliate company organization and legal frame work mainly from the perspective of company law and bankruptcy law. Financial regulation laws are touched upon because there are number of companies operating in the filed in the form of affiliate companies and certain developments in the area are illuminative in an attempt to develop regulatory framework for affiliate companies from company law perspective.

Third, the regulatory approach and experience of other countries are discussed not as comparative study but to develop the concept of affiliate company from Ethiopian perspective and for the purpose of adopting relevant solution. So, the study is by no means comparative one.

Finally, in laws of Ethiopia that are meant to address the protection of minority shareholders the study though there are provisions in the company law bankruptcy law and financial and creditors, only those deemed to form regulatory scheme in matters of affiliate companies are made the subject of discussion.

5. Methodology

a) Data Sources and sample selection

To study the organizational structure of affiliate companies in Ethiopia, it is necessary to limit the number of companies and group of companies in the following manner; first, the companies are registered both at the Central government Ministry of Trade and Industry, at City Administration and Regional government Trade and Industry Bureaus. So because of time and resource as well as the necessity to make a limit to the research those companies registered at the Ministry of Trade and Industry are made the domain for the selection of sample together with the financial companies regulated under the authority of National Bank of Ethiopia. Further because every member company in a group is not registered at the Ministry, each member of the group have not been considered.

In the study, the sample selection is made from financial and non financial companies. In financial companies from about twenty private bank and insurances, 12 of them are selected. i.e. about six groups containing bank and insurance. From non financial companies some six groups containing about total of 77 companies are selected for consideration. The sample selection is purposive and based first on the companies assumption of a group either in the name or advertisements made to the public one way or the other, on the basis of the size and complexity in their nature as in the case of MIDROC groups, and relatively longer duration of establishment in the case of the selected financial companies.Primary data was collected from Ministry of Trade and Industry for non financial companies selected, and National Bank of Ethiopia for financial companies to see organizational structure and means of affiliation among the companies. To see the practice few court cases are also found that are available on the issue at hand.

b) Interview

Interview is conducted with two officials at the Ministry of Trade and Industry working at the business registration and licensing, and legal department, one official at National Bank of Ethiopia, with two Insurance officers and one bank director, two Federal high court judges presently working on civil bench, three practicing lawyers, one federal supreme court judge, one federal first instance court judge and one commercial bank attorney. The interviewees are selected on the criteria that they are working in relation to regulation of affiliate company, relatively longer stay in practice and involved with the cases reported in the study due to their job. In this regard, due to its flexibility unstructured interview is employed in the research. Finally the data obtained are analyzed descriptively and analytically in light of the legal provisions on the subject under consideration.

6. Significance

The significance of the study may be seen from the perspective of those who are affected or benefited by the operation of the affiliate company, judges, practitioners, regulators as well as academics. The significance of the study is mainly in its analysis of problems passed by affiliated companies from the perspective of stakeholders. Particularly what judge and practitioners could do with the existing legal structure, in indicating the legal remedies available to creditors in case of abuse of benefit of limited liability through formation of affiliate companies.

Further the indicated inadequacy in the legal framework governing affiliate companies in Ethiopia will be an input (additional) to the already started revision of the Commercial Code. Finally, the study will be a contribution to the legal development in such marginalized area in law and practice. Particularly, it will make a way for further research in the area.

7. Limitation

One of the biggest limitations encountered by the writer in the research is scarcity of available material in the area in relation to Ethiopian law except one graduate thesis by Yitayal Mekonin and two undergraduate papers by Bruke Kefyalaw and Belayneh Kestela. [21] Moreover though there are many books written on the subject, they are not available in our library. Further the lack of official system of organizational establishment in the form of affiliate company and lack of awareness about the concept in regulatory, judicial as well as in practicing lawyer has limited the writer in getting necessary information and data to enrich the research with vast practical reality in the establishment and operation of affiliate companies. So, it was not easy for the writer to conduct the research in this circumstance. Hence, the writer had to heavily rely on internet and articles on journal, which is financially costy.

The paper is organized as follows: In chapter two various literatures are reviewed to discuss the definition, nature, purpose organizational growth, methods of affiliation and their management and control systems. Discussion is also made on the purpose and perspective of regulation as well as legal approach in regulating affiliate companies together with the experience of other countries. In chapter three, affiliate companies in Ethiopia, their organizational structure, how they are affiliated, whether there are presently legal frameworks relating to affiliate company, their adequacy and the current practice are examined. Finally conclusions and recommendation are made at the end.

[21] The Legal and Institutional frame work governing company groups in Ethiopia and the current practice (2009) piercing the corporate viel in corporate groups, 2003, The need for the regulation of group of companies in Ethiopia 2006" respectively.

Chapter Two

An Overview of Affiliate Company Organization and their Regulation

2.1. Concept, Nature and organization of Affiliate Companies

2.1.1. Concept and Nature

There is no clear definition of the phrase affiliated companies because of diversity in their method of establishment, and complexity in the organizational form they take for the purpose of operation. So resort to dictionary meaning is of some help. To begin with, the word affiliate is defined as being united, being in a close connection, allied/or attached or associated as a member or a branch.[22] A company on the other hand is a legally separate entity established for the purpose of running business activity without the members being responsible for its obligation. In Blacks Law Dictionary, affiliate company is defined as company effectively controlled by other company as branch, a division or a subsidiary.[23] So, roughly the phrase affiliate company signifies an association or relationship between two or more legally separate entities. It may also be named as group (of companies) which are made up of two or more companies, each of which has a separate legal existence but which are interconnected by reason of the power of control which one or several of them exercise over the other.[24]

At this juncture, it is important to differentiate between such terms as parent-subsidiary or holding company, sister or brother-sister companies. Parent company is a company owning more than 50% of the voting shares or otherwise controlling interest of another company where as a subsidiary is a company in which another company (parent) owns at least a majority of the shares and thus has control.[25] Holding company is a company that usually confines its activities to owning stock in and supervising management of other company.[26] Sister companies are two corporations having common or substantially

[22] Black, Henrry C. Black's Law Dictionary 6th ed. Paul Minn. West Publishing Co. 1991 P. 58
[23] Ibid.
[24] Le Gall, Jean-Pierre and Morel, Paul, French company law (2nd ed. 1992 Longman) P.240
[25] Supra note 22 P. 1114
[26] Ibid. P. 731

common ownership or same shareholders[27] Brothers-sister companies are more than one corporation owned by the same shareholders.[28]

Still without consideration of two important concepts or principles: corporate entity and limited liability, the definition of Affiliate Company would not be complete. Historically, the phenomenon of corporate groups was preceded in the 19th century by an almost universal acceptance of two fundamental doctrines on the subject and judicial status of companies: First that an entity once incorporated and, thus, sanctioned by the state become an independent legal subject separated in personam and in rem from its residual owners (i.e. shareholders), and, next in chronological sequence, the personal liability of equity investors to the creditors of such corporate entity was limited.[29] Corporate entity is defined as the distinct status of a corporation which sets its existence apart from the status of its shareholders, its capacity to a name of its own, to sue and be sued in its own name as well as the right to buy sell, lease and mortgage its property in its own name.[30]

In most jurisdiction, distinction is made between capital based companies and business organization based on the personality of members that are partnerships. Only capital based companies acquire corporate entity. This indicates that much weight is given to the capital of a company to endow it with separate corporate existence. So, raising and maintenance of capital is like keeping the blood and soul of a company. Without capital the company will die away. As a consequence of corporate existence companies enjoy the benefit of limited liability in almost all countries. Limitation of liability of members of a company has also led to the carefully drawn rules to prevent a company from wasting its money.[31] So, limited liability and corporate entity are two sides of the same coin, as it follows from the fact that a company is a separate person, its members are not as such liable for its debts.

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[27] Ibid P. 1387
[28] Ibid. P. 194
[29] Supra note 13 PP. 89-117
[30] Supra note 22 at 339
[31] Dine Janet and Koutsias Marros, Company Law, 6th ed., 2007 Plagrave Macmillan P. 21

The nature of affiliate companies are many fold. First, it ranges from a simple relationship that exists between two companies to a situation where 100 and 1000 of companies exist under the umbrella of one parent company forming complex pyramid, and sometime crossing state boundaries forming what is known as multinational corporations which are becoming challenge to the power of states.[32] Over 70 years ago an authority on the subject had asserted that corporations have become an institution which has brought such a concentration of power that so called private corporation are able to dominate the state, and even some time rival the state in the influence they exert on society.[33] Second, affiliated group of companies portray considerable flexibility in their organizational structure adopted for operational purposes, for taking management decisions and for measuring performance.[34]

Finally there is a marked tendency for diversification, even within groups, expanding into production processes, markets, product and services out side the scope of their original business activity.[35] In short affiliate companies are marked by the tension of its unity as a commercial enterprise and its diversity (or multiplicity) due to the legal segregation and insulation of its constituent companies. As a result, there will be divergence between the legal structure and the organizational structure of company groups.[36] The question then is what is the implication of affiliate company structure on the principle of corporate entity and limited liability? Do these both principles of company law subsist such corporate structure? If so how is the right of creditors to be protected? These constitute the general themes of the work.

2.1.2. Purpose of affiliation among companies

Depending on the type of investment whether huge capital is required or not individuals could establish a firm either as companies or partnerships. The economic foundation of a firm is consideration of transaction cost efficiency.[37] It is argued that transaction as well

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[32] Supra note 1 at 7
[33] Ibid.
[34] Ibid. P. 10
[35] Ibid. P. 6
[36] Ibid.
[37] Dine, Janet, The Governance of corporate Groups, (Cambridge University press,2002) P.8

as production cost will be efficient when individuals operate by establishing a firm than relate to each other by contract in a market, thus the job of a firm is to economize on transaction costs as when transaction are internalized within an enterprise, opportunism can be reduced.[38] The business strategies that produce affiliate company are generally similar to that produced firm or corporate form of organizations as alternative to do business by individuals. Hence, two or more independent companies operating or running a business could be more efficient when they relate as affiliate companies than through contract in a market. So, one of the strategy for the formation of affiliate company is to cut transaction as well as production cost among commercially interacting companies.

Second, affiliation between companies has also an advantage over contractual arrangement to exhaust organizational surplus value by building up long term cooperative arrangement, diffusing commitment in the organization, harmonizing interest, reconciling differences and orientation towards organization interest by convergence of expectations.[39] These could not be gained easily when two companies interact through contract in a market.

Thirdly, organizational arrangement into affiliate companies may also function as an efficient internal capital market by curtailing capital allocations to some activities and redirecting them to more promising activities[40] Reallocation through internal capital markets among separate entities subjected to control of common management occur either by diverting cash flow from one project to fund another or asset of one project may be sold to transfer the proceeds to another or the firm may implicitly borrow against the asset of one project to finance another venture.[41] These do not exist in unaffiliated companies.

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[38] Weston J. Fred, Chung S. Kwang and Hoag E. Susan, Mergers, Restructuring and Corporate Control, 2002 Prentic Hall of India New Delhi - 110001. pp. 26-40

[39] Teubner Gunther, Enterprise Corporatism: New Industrial Policy and the "Essence" of Legal Person. The American Journal of Comparative Law Vol. 36 1988 PP. 154-155

[40] Triantis George G. "Organizations as internal capital markets: The Legal Boundaries of Firms, Collateral and trust in commercial and charitable enterprises", Harvard Law Review Vol. 117, 2004 P. 1111

[41] Ibid P. 1111, 1106

Fourthly, companies may also take affiliate arrangement for tax consideration i.e. a special tax treatment that may be available under tax legislation for companies in a group could also be an incentive for the formation of affiliate companies.[42] That is the case when tax law permits the setting off of profits against losses within a group of companies particularly in groups that employee a consolidated income statement and in tax system where double taxation is avoided.[43] Double Taxation arises as follows: The profits of the subsidiary are taxed first; dividends based on the profits which are distributed to the parent are again taxed as profit. Finally the share holders of the parent company must pay taxes on the dividends they receive.[44]

Fifthly, limiting liability may also be a factor for the formation of affiliate companies organizational arrangement. As individuals incorporate their business to benefit from limited liability so does companies particularly where the enterprise is to embark upon some new high risk venture.[45] The fact that the legal independence of the affiliated company is preserved even when an affiliated group is established, assures at least in principle that liability will be limited to the individual member companies.

Finally, separate corporate units may also be formed to capitalize on the skills developed in one line of activity, to gain economies of scale and there by make huge investment. Moreover, the formation of an affiliated group creates the possibility of acquiring control of economic resources with a relatively small investment of capital.[46] That is, control of a company leading to the formation of an affiliated group may be acquired by purchasing only a majority of shares or at a little more than one half the price of the entire enterprise which even could be reduced when ownership of the company's shares is widely dispersed.[47]

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[42] Supra Note 1 at 11
[43] Immenga Ulrich, Company system and affiliations, International Encyclopedia of Comparative Law,(Conard, Alfed ed,1985,Martinus Nijhoff publishers, The Hague)Vol.XIII P. 5
[44] Ibid.
[45] Supra Note 1 at 11-12
[46] Supra Note 43 at 5.
[47] Ibid.

2.1.3. Organizational Growth and Method of Affiliation among Companies

A) Organizational Growth and Expansion

Business activity involves transaction among individuals for the exchange of goods and services for money. Contractual relationship from simple to complex underlies such business activity. As business could be done between individuals, it could also be done through interaction of two or more corporate organizations. Two or more independent companies operating in an economy make transaction amongst themselves either through contractual arrangement or by expanding their organizational boundaries i.e. including number of companies under the same enterprise.[48]

Contractual relationship may be one firm supply raw material, the other produce goods and services, the other distributing and marketing. Instead of interacting through contract in the market, an entrepreneur may opt to put these set of activities and functions under the same organizational boundary but arranging them in units having separate legal existence for above discussed reasons of affiliation and sometimes by motivation of organizational growth as an appropriate end to pursue saying the bigger is better.[49]

i) Internal expansion

There is wide range of industrial or commercial activities that could be run by formation of companies. These economic activities for the production of goods and services and allocation of same require variety of organizational arrangements because there are complex set of process or chains to complete the production of such goods or services. Thus grouping of companies promote the division and allocation of such function as production, supply, marketing, sales and research and developments to be undertaken by legally separate entities.[50] Since the companies in the group have independent legal

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[48] Davis F. Gerald, Diexman A. Kristina and Tinshey H. Gatherine The Deline and fall of the conglomerate firms in the 1980s: The De institutionalization of organizational forms, American Sociological Review 1994 Vol. 59 P. 552

[49] Ibid.

[50] Supra note 43 P. 4

existence, the enterprise as a whole can be organized with the greatest measure of flexibility.[51]

For instance an organization for manufacturing of a certain product may wish to have its own marketing out let for its product by a separate company; or the same manufacturing company may also wish to include in its boundary the activity for the supply of input by establishing another company.[52] Conversely, an already existing large company may wish to put its undertaking or the several different businesses carried on by it into separate business managed by separate companies.[53] In the former case internal expansion is achieved by capital investment in an enterprise while in the latter case a company is split and arranged into number of firms without making further investment.

These processes result in vertically related form of affiliated companies. Vertically related companies are those incorporated or acquired in such a way that one entity will supply the raw material for the production of a given goods and services and the other as a marketing outlet for the product as a result of which the activities are chained just like series of processes in an industrial activity.[54] Such kind of organizational growth are usually related in parent – subsidiary relationship. The main company will be the parent while the other supply or marketing out lets will be subsidiary. It is the main company that wants to expand its organizational boundary and it takes initiative to organize the subsidiaries.

ii) External expansion

External expansion is usually brought about through the consolidation of previously independent business units as when business enterprise grows through takeover of one company by another or mergers of two or more companies.[55] In the case of takeover it may be that a supplier of raw material or the marketing outlet that may be the target

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[51] Ibid.

[52] Pennington Robert R., Pennington's Company Law, 6th ed. 1990.(Butter and Co. Publishers Ltd., London, Dublin, and Edinburgh) PP. 729 - 730

[53] Ibid.

[54] Ibid.

[55] Ibid.

resulting in parent-subsidiary relationship as in the case of internal expansion. It may also be the case where by takeover, a new company may be formed to acquire the shares of the existing companies and the latter become subsidiaries of the former carrying on their respective business subject to the common control of the former (holding company).[56] Merger as a means of organizational growth through external expansion may also take two forms: merger by absorption and merger by incorporation; in the former one company absorbs another while in the latter case both merging companies cease to exist and a new company is established which is also called consolidation.[57]

As opposed to vertical growth, companies may also grow horizontally. In this case the activities are not chained in series; rather the firms are involved in the production of related goods or services. If acquisition or takeover takes place between competitor companies, a horizontal form of affiliation will be created. In this case the companies produce goods or services which are substitutable.[58]

One can also, imagine another form of affiliation among companies through external expansion of organizational boundaries when it diversify its line of business by establishing or acquiring number of companies to run activities which are commercially or economically unrelated called conglomerates.[59] In conglomerate organizational form, the corporations are relatively autonomous business units operating in numerous unrelated or weakly related industries and a corporate headquarters acting as an internal capital market allocating resource among the units.[60] In American industry, this form of organizational growth was followed during 1960s as a result of the then anti trust or anti-competition policy which discouraged vertical or horizontal growth of companies.[61]

Finally external expansion of an organization may also be said to occur when a company grow externally by investing its cash in the shares of another company to the extent of

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[56] Ibid.
[57] Oda Hiroshi, Japanese Law, 2nd ed. (Oxford University Press, 1990) P. 261
[58] Supra note 52.
[59] Ibid.
[60] Supra note 48.
[61] Ibid.

controlling the voting power of the latter or the same individual shareholders may expand their business by forming different independent companies.

Generally the implication of such considerable freedom of capital organizations, both in law and in practice, to determine the limit of their boundaries is that the decision with respect to firm size also has a profound bearing on the potential liabilities of the company as a result of the limitation of legal responsibility to the firms own action and omission.[62] This is known as the capital boundary problem-because the firm determines its own size, it also chooses the limits of its legal responsibilities which in turn provides an open invitation for the evasion of legal duties.[63]

B) Methods of Affiliation among companies

There are many methods of forming corporate alliances or affiliation among companies: ownership, contract and authority arising either from partial ownership or contract.[64]To explain some of them, first the most important method of bringing about affiliation is acquisition of a company's share, either the shares of a company under formation when it is a share company or an investment in the share capital of an already existing company.[65] Share acquisition could be one sided as where only one of the group acquires the share of another and not vise versa, or both or many companies in a circular arrangement own each others share which is known as joint holding.

In most jurisdiction, where one company acquires 10 percent or more of another company's share that other company is prohibited from owning or holding shares in the first company.[66] Acquisition of share may go to the extent of purchasing controlling block of its shares which is the method of acquiring not only share but also the right or power to manage the acquired company.

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[62] Collins Hugh "Ascription of legal Responsibility to Groups in complex economic patterns of economic Integration" in The Modern Law Review, 1990 Vol.53 No. 6 pp.736-737
[63] Ibid
[64] Ibid pp.733-734
[65] Supra note 43
[66] Ibid.

Second, enterprise agreement is the other method for the formation of affiliation among companies. It consists in control agreement, management contract or business lease.[67] Control agreement exists when one company contractually agrees to submit to the management of another enterprise, while in management contract company agrees to transfer the management of its business affair to a second company without right of control.[68] Contracts of reciprocal obligation like credit relationships, long term supply contract etc may also be mentioned as methods forming affiliation among companies.[69]

Thirdly interlocking directors or officers between companies may also give rise to affiliation. There are limits for allying a group of companies in this way though permissible in principle.[70] In Anglo-American board system whether a director is acting on behalf of a competing company is one of the factors to be considered whether to limit common board membership.[71] In any case, when companies having common directors or offices engage in dealings with each other like entering into contract between the companies, conflict of interest is likely to arise.[72] Finally, affiliation among companies may be established by voting agreement, share with multiple or no voting right.[73] In the absence of possession of controlling interest such various techniques can be employed to obtain sufficient voting power to exercise control.[74]

2.2. Management and Control in Affiliate Company

A) Management of single company

Once companies are established as separate legal person, it would have the capacity to engage in economic activity and doing judicial acts but only through human agency. Management of a company are structured in to different organs such as shareholders meeting, board of directors and officers of the company. These are mandatory organs for publicly held (or share companies) where as for closely held (or private limited

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[67] Ibid. P. 30
[68] Ibid.
[69] Ibid.
[70] Ibid. P. 35
[71] Ibid.
[72] Ibid.
[73] Ibid P. 27,
[74] Ibid.

companies) board of directors as well as general shareholders meeting are not available organ, it is only management of the company that runs its day to day activity.

These organs have their own specific functions!- first general shareholders meeting have a significant place in the management of a company for shareholders have an inherent right to vote in the decision of a company, particularly in the appointment of directors or auditors, decision concerning their remuneration, approval of statement of account decision about dividends and amendment of company constitution.[75] Second board members being appointed by general shareholders meeting have the power to appoint officers of a company and set basic corporate policy where as officers are responsible to run the day to day activity of a company.[76]

So, in a corporate management structure powers are transferred from one organ to another from shareholders meeting to board of directors from directors to officers. Though the internal structure of corporate governance in share companies includes relatively independent managing board, which is directly responsible for pursuing corporate interests, the participation of shareholders at shareholders meeting to realize their own parallel and sometime conflicting proprietary interest in the company had brought about the principle of majority rule.[77] Shareholders having majority ownership have the power to control the company because it could command appointment of director it likes and the directors in turn the officer it likes. In a publicly held corporation characterized by dispersed shareholding because of separation of ownership and management, one can say majority ownership will not entail control by majority shareholders.

But still, they continue to control the management of the company. To elaborate on this point further,[78] at the time a company is created, the shareholders, directors and offices

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[75] Prentice Robert A. Law of Business Organization and Securities Regulation, 2nd ed. Prentice Hall, Englewood, New Jersey 07632, 1994 P. 307
[76] Ibid.
[77] Supra note 43 at 6
[78] Hessen Robert. The Modern Corporation and Private Property. A Re Appraisal, Journal of Law and Economies Vol. XXVI, 1983 P. 288

may be the same people, as shareholders elect themselves board of directors and appoint themselves as corporate officers. When the corporation later goes public, the founders accept the possibility of a dilution of control because they value additional capital and because they expect to continue to control a majority of vote on the board and thus to direct the companies future policy and growth. In this way board of directors are dominated by insiders, which entail control of company management by majority shareholders. In case of private limited companies since ownership and management are not separated (i.e. shareholders are managers themselves) it is naturally inside controlled. In such companies minority shareholders are at the mercy of the majority shareholder and usually rely on him/her to be fair and to consider their interests.[79]

B) Management and control in Affiliate Company

In affiliate company situation, the question is what does the management structure look like, how do separate member companies of the group relate to each other with respect to management and the like. Basically the organs for the management of companies should be the same whether they are single and independent or affiliate and interdependent. But, in affiliate companies, a corporate shareholder may have majority ownership to dominate at general shareholders meeting in the decision of appointment of majority of board members. This results in the control of one company by another member in a group. That is, although the composition of managing board is determined at the shareholders meetings, it is helplessly exposed to the domination of an outside interest in the form of majority shareholder which deprives the board of its independent function and subjects it to the instruction of others.[80]

In this way, more than one company in affiliate relationship practically falls under common management. That is board members and officers of one company are elected or appointed by another company because of the majority ownership or shareholding. This disruption is not merely formal but substantial and material. Since the company now pursues extrinsic business interest namely the interest of the group, the principle of

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[79] Shepherd J.C. The Law of Fiduciaries (1981, The Carswell Company Limited Toronto, Canada) P. 354
[80] Supra note 43 at 6

company law such as the role of managing board, the application of profits and the conservation of asset of the company are not valid here.[81] Some of the consequence of such control structure in affiliate companies includes; transfer prices fixed by controlling company without any relationship to market conditions, inadequate consideration paid by controlling company, and extension of credit to the controlling company at a lower rate.[82] Further the influence on company management does not stop at impairing the asset of the affiliate company, it extends to the group company serving the interest of the controlling company in the group like isolating the company from the open market by restricting it to transactions with other members of the affiliated group; relocating sale market or limiting investment etc.[83]

So, control and influence in affiliated group of companies does not only disrupt the legal structure of authority within a company, it directly jeopardize the assets of the affiliated company threatening both the interest of individual affiliated company and those interest allied with the company like minority share holders and creditors.[84]

2.3. Regulation of affiliate companies

In today's world where business is increasingly conducted by interrelated group of companies, traditional corporation law fashioned to serve the needs of largely agrarian society is insufficient to regulate the present economic reality in the field of corporate activity.[85] "The legal concepts of entity law originating in the context of simpler economic order can no longer properly cater for a world dominated by complex corporate groups."[86]

The lawmakers and the judiciary of different countries, recognizing the need for the regulation of affiliated group of companies that have become major centers of economic power in the society, are responding both statutorily and judicially to the modern

[81] Ibid.
[82] Ibid. P. 7
[83] Ibid.
[84] Ibid. P. 6
[85] Supra note 1 at 27
[86] Ibid. P. 28

corporate structure in different legal systems of the world, particularly in both developed and emerging economies. In this section, we will see generally the purpose of regulating corporate grouping structure, the perspectives and approaches of regulations.

2.3.1. Purpose of regulation

A) Legitimacy of the organization and protection of investors

The growth and expansion of companies in to affiliation to form corporate grouping structure has become quite a normal phenomenon in developed as well as developing economies. Then the question is whether affiliate company structure is a legitimate form of organization or not. In this regard in countries where special regime has been established as part of company law reform like Germany, Brazil, Italy and Portugal, there is no doubt that the legitimacy of the organizational form is explicitly acknowledged.[87]

In countries where there is no such special regime or equivalent legal discipline, the legitimacy of affiliate company organizational form may be accepted on the basis of two factors,[88] on the one hand, basically the recognition of market system and corporate freedom in constitutional rules of economic nature, the formation and operation of the group is a legitimate economic reality. On the other hand, in some countries though there is no special regime for regulation of affiliate companies, there are abundant legislative references to company groups in company law and/or other branches of law.

Since the formation and operation of affiliated group of companies is a legitimate entrepreneurial reality, the following interest may be identified in the relationship as a whole: the interest of the group, the interest of individual member companies, the interest of minority investors in member company and finally the interest of creditors.[89] In a group of company relationship, regulation is ordinarily aimed at protecting the interest of member companies, that of minority shareholders and creditors of member companies, against the abusive control of dominant company in the group. Nowadays however there

[87] Embid Irujo Jm, "Trends and Realities in the Law of Corporate Groups" in European Business Organization Law Review 2005 Vol. 6 P. 68
[88] Ibid.
[89] Supra note 1 at 25

is an increasing need to recognize the interest of the group as a whole, which is an emerging paradigm in the context of the purpose of regulation of affiliate companies for the protection of both majority and minority investors.[90]

Then, how is the interest of these categories of investors' conflict with each other in affiliate company relationships? Is there any difference between single company model and affiliated group of companies as regards protection of investors? Is the conflict situation different where the corporate units are relatively autonomous like the case in diversified corporate groups or conglomerates? Usually in a single company model diversity of interest could exist between majority and minority shareholders. But sine there is only one company, in a single company model decision of the management is to be made by considering the interest of that particular company as expressed by the majority or controlling shareholders. In case of affiliate company however, there is an interest of the group as a whole apart from the interest of individual member companies. That is, the parent company holding the majority in subsidiary company may decide to subordinate the interest of the subsidiary to that of the parent, to the detriment of minority investors in a subsidiary.

Affiliate corporation even when engaged in a totally unrelated lines of business will be managed differently from independent firms because the owners will still seek to maximize the profit of the enterprise as a whole rather than the profit of individual corporate unit.[91] So, the primary reason for special regulation of company system thus is the likely influence of member company by out side business interest than its own corporate purpose.[92] Therefore it is necessary to regulate affiliate companies so as to balance the interest of such different category of investors. That is not only minority shareholders in a controlled company but also the controlling company and its

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[90] Ibid.

[91] Posner Richard A, The Rights of Creditors of Affiliated Corporations. The University of Chicago Law Review. Vol. 43 1976 P. 513

[92] Supra note 43 at 6-7.

shareholders interest needs to be taken in to account in formulating regulatory scheme for corporate groups.[93]

B) Protection of creditors

In no other place than in business is the interactions among different persons in the capacity as debtor and creditor is prevalent. So, the analysis of legal regime governing affiliate companies (if any) will not be complete (even half complete) with out the consideration of the place of creditors. What makes different the interest of creditors in affiliate group of company situation is; on the one hand, each member company in the group has their own separate legal existence, that one company will not, legally speaking, be liable for the debt of another. On the other hand, economically the companies in such affiliate relationship may not operate independently of each other as there could be chain of control among them and the controlled company may be used to pursue the economic interest of the whole group than its own interest.[94]

In that case, creditors of the controlled company may not get the performance of their obligation from the company not pursuing its own interest and because of the legal entity doctrine they could not easily go against the other member company in whose interest the debtor company was working. So, the risk to creditors is either in the principle of limited liability or in the loss of corporate economic independence in companies affiliated with other companies.[95]

The following question may be raised to explain risk to creditors in affiliate company situation. Is the risk to creditors different in affiliate company situation than in single company model? Is the interest of creditors affected equally in all forms of affiliated companies related either vertically, horizontally or in conglomerate forms? In all the three forms of affiliation, each member of the group as a company has separate legal existence. But the degree of economic independence of each member and the risks to

[93] Supra note 87 at 70
[94] Supra note 43 at 6-7
[95] Frankel, Tamar, Book Review, "Company Systems and Affiliations" in American Journal of Comparative Law, 1988, Vol.36 No.1 P.163

creditors varies across the forms depending on the interrelation of the economic activity undertaken by each member of the group.

In a vertically related companies the degree of control and integration is higher and there is a greater loss of economic independence or autonomy which involves greater risk to creditors, where as in the conglomerate form of affiliated group of companies the degree of autonomy of member companies are higher because each units in a group are engaged in unrelated or diversified activity and thus the risk to creditor is relatively less in such form of affiliate companies.

Even when engaged in totally unrelated lines of business, the risk to creditors of companies in a group are different from creditors of single independent firm, for the simple reason that owners in a group of companies may seek to maximize the profits of the enterprise as a whole than the profit of any individual corporate unit.[96] Generally some of the dangers faced by creditors of affiliated group of companies include corporate management decision with a view to over all return on investment than profitability of particular unit, artificial allocation of property among constituent company, and inadequate initial capitalization.[97]

2.3.2. Perspectives of Regulation

A) Organizational Versus protective regulation

Organizational or protective perspective is the two basic outlooks from which legal rules for regulation of affiliate companies may emerge.[98] These perspectives reflect the political economy behind given legal system. The starting point is that any regulation of corporate groups should do two things:[99] First it should establish legitimacy for the promotion of interest and legal safety for the group operation. Second, it should also has to put forward measures for the protection of those that may suffer from the primacy of the groups interests over those of the constituent companies.

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[96] Supra note 91 at 513

[97] Lander Jonthan M, "Another word on parents, subsidiaries and Affiliates in Bankruptcy", in The University of Chicago Law Review. Vol. 43 1976 P. 528

[98] Supra note 87 at 70

[99] Ibid.

In the views of organizational regulatory perspective, corporate grouping structure is regarded as an entrepreneurial reality and hence regulation should provide safe guidelines for the operation of the group and for the ongoing interaction between the member entity and in particular between their organs.[100] Nowadays there has become an understanding that groups *per se* are not necessarily harmful to the interest of the member companies as sometimes the best way to fulfill the particular interest of a given company is to include it in a group.[101]On the other hand, the protective perspective of regulation is based on the view that affiliate company relationship is a risky institution.[102] According to this perspective the regulatory framework has to play guardianship role over those negatively affected by the creation and operation of the group-the external shareholders and creditors.[103]

Both organizational as well as protective views of regulation are not opposed to one another and hence both should be taken in to account without underestimating any one of them. That is, a suitable balanced combination of the two views seeks to defend corporate freedom while protecting the weakest interest at the same time.[104]

B) Singular versus plural regulation

On numerous occasions company law has been said to constitute the *sedes materiae* of affiliate company regulation, though legal references outside the field of company law are quite frequent in most legal systems.[105] These are tax law, labour law, competition law, and financial market regulation and bankruptcy laws. So, whether to have a single exclusive regulation or different ways of legally ordering corporate groups within the same legal system is question that needs to be considered. The plurality of regulation do not necessarily imply the existence of a homogenous legal regime with regard to affiliate companies operation in the economy in the existence of different group concepts, diverse

[100] Ibid.
[101] Ibid. at 82
[102] Ibid.
[103] Ibid. at 79
[104] Ibid.
[105] Ibid.

and even conflicting legal policy perspective in different branch of law.[106] Therefore it is preferable to have some sort of generic regulations that facilitate the harmonization of the treatment of affiliate companies around common criteria.

2.3.3. Regulatory Approaches and the experience of other countries

A) Group or Enterprise Liability Approach

In the group liability approach, when one company out of the companies forming affiliation had a controlling influence in the management of another; in spite of their separate legal existence, their will be liability of one company for the debt of another controlled company under special regime regulating affiliate companies from company law perspective. In this approach is the German group law which is the most advanced in the world[107] and that of Italy will be discussed. Under enterprise liability approach the emphasis is on the size and complexities of an organization instead of the legal form of the company.[108]

i) Germany

The German stock corporation Act of 1965 had identified three type of groups or concern: integration concern, contractual concern and de facto concern.[109] In integration concern, the parent has go to 95% majority ownership in the subsidiary in which case the shareholders of the two company may agree to integrate and the parent company will control in the management of the subsidiary.[110] In this type of group, the parent is joint and severally liable for the creditors of the subsidiary and the external shareholders have the right of separation against payment of fair price for their share.[111] The contractual concern case is the control agreement entered in to by the shareholders of the two companies against payment of compensation in case of damage to the subsidiary.[112]

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[106] Ibid.

[107] Hofstetter, Karl "Parent Responsibility for Subsidiary Corporation: Evaluating European Trends" in the international and comparative law quarterly Vol 39(3) 1990 P 578

[108] Raiser T. "The Theory of Enterprise Law in the Federal Republic of Germany" in American Journal of Comparative Law 1988 Vol. 36 No. 1 P. 114

[109] Supra note 107 at P. 581

[110] Ibid.

[111] Ibid.

[112] Ibid.

Creditors of the subsidiary have the right to enforce compensation claim against the parent where as external share holders have the right to enforce the control agreement.[113]

In de facto concern type of affiliation when the parent company without any formal control agreement had controlled the management of the subsidiary on the basis of majority stock ownership and when it is proved that damage had caused to the subsidiary as a result, there is a right for compensation against the parent for the subsidiary.[114] The creditors of the subsidiary may also have derivative claims against the parent company for the debt of the subsidiary company.[115]

The stock corporation act of Germany does not include affiliate companies when the member company in the group is not public company where as, a result of such legal gap; the German courts had developed the doctrine of "qualified concern" for close corporation subsidiaries.[116] In such cases if the parent company permanently and extensively involves in the management of the subsidiary, the courts allowed creditors of the subsidiary company to directly claim or sue the parent company for the performance of the subsidiary company obligation.[117] This judicial extension of parent liability provides wider protection for creditors as compared to the statutory protection because in this case there is no need to prove cause and effect relationship between control of management by the parent and damage to the subsidiary; and creditors claim is not derivative rather direct against the parent company. Put another way, if the creditors of the subsidiary prove control by the parent, unless the parent can defend itself that in spite of the control it has shown sufficient consideration for the subsidiary, it will be liable for the creditors of the subsidiary.

The German courts had ventures out on fairly "thin ice" when it adopted qualified de facto concern doctrine in an attempt to apply enterprise liability approach to cases

[113] Ibid. P. 580
[114] Ibid. P. 582
[115] Ibid.
[116] Ibid. P. 583
[117] Ibid.

involving close corporation subsidiaries not regulated by statutory regime.[118] Though the German constitutional court held it to be constitutional, the court itself (Supreme Court) retreated from the "thin ice" abandoning in *to to* of any application of corporate group liability concepts to qualified factual concern.[119] In a way the German courts shifted to mandatory capital maintenance liability system in cases involving limited liability company and thus piercing the corporate veil has become the courts exclusive conceptual premise of direct shareholder liability.[120]

Generally what we can observe as discussed above from German group of company regulatory scheme is that, first, the interest of the group as a whole is recognized in that, to the extent the controlling company can compensate the controlled company, it has the right to control in the management. Apart from explicit recognition of legitimacy of the affiliate company organization, the groups' interest is recognized and protection mechanism is devised. The controlled company right to compensation is also a protection mechanism for member companies. The right of external shareholders and creditors are also recognized and protected as discussed above.

Hence, the distinctive and central body of German parent liability law has been the concern law, though other areas of law such as contract, tort, bankruptcy and even piercing the corporate veil serves functional equivalent to concern law in the regulation of affiliate companies in Germany.[121]

ii) Italy

Italy with in the framework of the countries general company law reform revised its company law to add a new chapter on corporate groups, under the heading "corporation management and coordination".[122] The rules are intended to make group situation public by making their structure and the links among member companies more transparent; to be

[118] Reich Graefe R. "Changing paradigms: The Liability of Corporate groups in Germany" in Connecticut Law Review (2005) Vo. 37 PP. 796-887
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] Supra note 87 at 84

effected through compulsory registration in the registers of companies of the subordination status between the companies and indication in the directors report of the links with remaining group members.[123] In the rule appraisal right is provided as protective mechanisms for minority shareholder.[124]

Further if the company in charge of the management and coordination of the companies violets principle of correct corporate and entrepreneurial management of companies, it is liable before subsidiary for damage to the profitability and corporate participation value and before creditors for any harm to corporate assets.[125] Under the new section 2497 paragraph 1of the code, it is provided that:

> *companies or legal entities which - in carrying out direction or coordination activities on other companies - act in the interest of their own or third party business, in breach of correct corporate management are directly liable: (i) Vis à vis the shareholders of the directed/coordinated complains for the damage occurred to the profitability and value of their shareholding; and (ii) Vis à vis the creditors of the same companies; for the damage occurred to the integrity of the corporate assets.*[126]

A number of conditions must be shown for controlled entity or creditor to succeed in a suit against controlling company which likely run in to trouble when it becomes necessary to prove causation of damage and quantity as well.

B) Consolidation in Bankruptcy

In this regulatory model, if companies form a group and operate in the market through chain of affiliation, the law for the purpose liability rarely steps in how they are inter related and interacting up until one or more of the company among the group become insolvent. At the time of bankruptcy, proceeding of one or more affiliate companies, to determine liability, the court could consolidate the bankruptcy proceedings of the affiliate

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[123] Ibid.
[124] Ibid.
[125] Ibid. P. 86
[126] Delfino, Maurzo, Rules Finally address Corporate Group Control, available at http://lfrl.com/Article/1984858/Rules-Finally-address corporate group control.html

companies. This approach is mainly followed in France, where detailed procedure are set for the extension of the subsidiaries bankruptcy proceeding to include the parent.[127]Not only the parent but also persons who are or have been responsible for the management or control of a company may a generally be made liable for its debts to the extent that its assets are insufficient to meet such debts.[128] France, though it had not codified comprehensive group law, it had taken a restrained but conceptually interesting approach to parent company liability.[129]

Under France consolidation in bankruptcy approach, there are two basic category of extension of bankruptcy proceeding to the parent: substantive consolidation and statutory consolidation cases.[130] Substantive consolidation is to be applied where the assets and affairs of a parent and subsidiary corporation have been so closely intertwined that the latter is to be considered a mere instrumentality of the former.[131] In this case, if one or more of the affiliates or subsidiaries are insolvent, their creditors could claim against the parent for the payment of debt of the affiliates or the subsidiaries in the bankruptcy proceeding. The question in this case is, what if the company in the group which is going to be liable for the creditors of another member company is still solvent? Should the bankruptcy of the insolvent company be extended to the solvent company?

The second case of consolidation in bankruptcy under French system is statutory consolidation which applies where a parent company had been acting as a director of the subsidiary whether it is formally elected as such or with out such formal election just involves itself in the subsidiary's day to day management.[132] So under statutory consolidation in a parent subsidiary relationship, the parent is liable for the creditors of the insolvent subsidiary due to its influence in the management of the subsidiary but not because the subsidiary is a mere instrumentality of the parent as in the case of substantive

[127] Supra note 107 at 584
[128] Supra note 24 at 292
[129] Supra note 107 PP. 583-584
[130] Ibid.
[131] Ibid.
[132] Ibid. P. 585

consolidation. Creditors are required to show only the influence of the parent in the management of the subsidiary as formal or defacto director.[133]

Apart from consolidation in bankruptcy as part of France corporate group regulatory regime, there are also two alternative parent liability scheme: directors duty and labour law. In the first case when the parent company has become formal or defacto director of the subsidiary, on the basis of director's fiduciary duty principle, the parent will be liable for the creditors of the subsidiary.[134] But the difficulty of proof of the parent as director of the subsidiary, the violation of the fiduciary duty and proximate causation of damage to the subsidiary, the regime of parent director liability is not frequently used by subsidiary's creditors in France.[135]

Under labor law, if a parent had directed the subsidiary in hiring decision or gives work instruction to the subsidiary employees, it automatically assumes joint and several liabilities to the subsidiary's employees.[136] Under this regime, the employees are not required to initiate the bankruptcy proceeding against subsidiary; they can directly sue the parent.[137]

C) Anglo-American approach of piercing the corporate veil

Piercing the corporate veil doctrine is a judicial process where by courts disregard usual immunity of limited liability from shareholders. It is also defined as . . . (T)he doctrine which holds the corporate structure with its attendant liability of stockholders, officers and directors in the case of fraud or others.[138] The doctrine is much practiced in courts of common law legal system of England and United States as compared to civil law countries. It was first introduced by the American courts in the fundamentally different

[133] Ibid.
[134] Ibid.
[135] Ibid. PP 585-586
[136] Ibid.
[137] Ibid.
[138] Supra note 22 at 795

economic world of small corporations with individual controlling shareholders and latter on adapted to cases involving corporate shareholders.[139]

In both jurisdictions the core of corporate jurisprudence lies in the general rule that a corporation separate legal entity limits creditors' right to the asset of the corporation. That is the liabilities of member companies in a group are those of the individual companies which incur them and there is no common group liability, imposed by law for the obligation of individual member of the group.[140] Exceptionally however courts pierce corporate viel and reach the asset of one member company (the parent) for the debt of another member company when there is abusive control causing damage to the controlled company.

There are two requirements for courts to apply the doctrine of piercing the corporate viel: domination and improper use of that domination.[141] Domination or "alter ego" or "instrumentality" as it is also called goes on the premises that as a separate entity corporation should act for itself not for its shareholder; if however the share holder causes the corporation to act to its detriment and to personal benefit of its shareholders it has become a mere instrumentality or alter ego (other self) of the shareholders.[142]

Though the grounds for piercing the corporate viel varies from jurisdiction to jurisdiction and from courts to courts, the following may generally constitute a ground for the existence of domination and improper use and; hence a foundation piercing the corporate veil.[143]

a) Lack of separate corporate organization such as separate officers, plants, employees, equipments, telephone,

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[139] Blumberg Phillip I. Book Review, "Regulating Corporate Groups in Europe" in The American Journal of Comparative Law, Vol. 40 No. 4, 1992 P. 1018

[140] Supra note 52 P. 748

[141] Metzger B. Michael, Mallor P. Jane, Barnes James A., Bowers Thomas and Phillips J. Michael Business Law and the Regulatory Environment (1992, IRWIN, Homewood, IL 60430 Boston MA 02116) P. 909

[142] Ibid.

[143] Supra note 18 at 64

b) Lack of compliance with corporate formalities such as failure to hold meetings, absence of minutes of meetings, lack of records, books of account, tax return or report,
c) Lack of adequate capitalization commensurate to the risks and scale of enterprise undertaken,
d) Shareholders directing corporation to pay personal expenses of shareholders,
e) Transfer of corporate assets to themselves or affiliate corporations other than for adequate considerations.

In these jurisdictions, veil piercing is more frequent in the case of closely held corporation as compared to large corporations as the danger of abuse of corporate form is greater in the case of small business.[144] Nearly all corporations where viel are pierced to reach the asset of shareholders are close corporations since domination is more easily accomplished in a close corporation than in a publicly held one.[145] Such a trend is in line with proposals for unlimited liability regime for small corporation: "We would expect unlimited liability might be an efficient rule for closely held or small companies. In fact we observe that for small companies with limited liability creditors often require personal guarantees. This converts limited liability company into one with unlimited liability."[146]

It is also important to notice the slight difference between viel piercing in American and viel piercing in England. American courts have no rigid adherence to separate corporate entity when it is necessary to promote justice or obviate inequitable results.[147] Apart from the liberal approach to the doctrine of lifting the corporate viel by American courts, there are governmental attempts to regulate the great corporations dominating the key industries in the American society by statutory enterprise liability standard.[148] In light of such widespread acceptance of enterprise principles in American statutory law and their

[144] Supra note 91 P. 515
[145] Ibid.
[146] Paul Halpern, Michael Trebilcock and Strart Turnbull,An Economic Analysis of limited liability in corporation law, University of TORONTO Law Journal, 1980 Vol.30 p.135,148. See also Leebon, David W. Limited Liability, Tort victims and Creditors, Columbia Law Review 1991 Vol.91
[147] Supra note 1 P. 256
[148] Supra note 139 at 1016

growing utilization in judicial decision, the emerging American corporate group law is exceeding that of Europe.[149]

On the other hand the English piercing the veil doctrine can play a limited role as it applies only to case of sham or shell subsidiaries.[150] That is, U.K has strictly adhered to the entity approach and limited liability doctrine. It is the jurisdiction that less likely lifts the veil of a corporation in order to impose liability on the parent for the obligation of its subsidiary.[151] It is rather based on extending creditor protection rules to deal with specific needs of group creditors, like rules for allowing liability of shadow directors.[152] The basis of such liability is the requirement of entity approach; that directors of a company must act in its best interest and thus directors of subsidiaries can not act in the parent company's interest at the expense of subsidiary's interest. Moreover the British company act of 1985 as added by the Companies act of 1989 requires, on top of a parent company individual account, it must prepare group accounts at the end of each year.[153] So, generally piercing the veil jurisprudence is "the raw material" out of which corporate group law is emerging in these jurisdictions.

[149] Ibid. P. 1019

[150] Supra note 1 at 255

[151] Sandra K. Miller, Piercing the corporate viel among Affiliated Companies in European community and in the U.S. A comparative Analysis of U.S., German, and U.K. Viel piercing approaches 1998, American Journal of Business Law Vol. 36 P. 73

[152] Supra note 37 PP. 42-55

[153] Davies Paul L. Principles of Modern Company Law, 7th ed. London: Sweet and Maxwell, 2003 P. 203

Chapter Three

Organizational structure, legal rules and the current practice in relation to affiliate companies in Ethiopia

3.1. Organizational Structure of Affiliate Companies

3.1.1. General

The number and modalities in the formation of companies have direct relationship with the economic policy of the country. The significant shift in Ethiopia's economic policy direction to encouraging private investment since the present government took power in 1991 had brought about a marked increase in the number of companies established in the country. For instance, before 1991 G.C the total number of private limited companies registered at the Ministry of Trade and Industry was 281, while by June 2009G.C the total numbers of private limited company registered at the Ministry have become 9,860.[154] This means private limited companies percentage increase in number for the past two decades is 97%. Further the total number of share companies registered at the Ministry of Trade and Industry before the year 1981 G.C was only 41 while the total numbers of share companies registered at the Ministry have become 393 by the Jun 2009 G.C.[155] The percentage increase in the number of share companies in the past two decade is 90%. So, one can say that the formation of private companies are flourishing in the country. It is important to notice here that presently private Limited Company is the most preferred form of business organization in Ethiopia.

Moreover, the business owners in the country are taking the freedom to structure their companies not only as a single unit, but also as a number of Affiliated Companies that have wide range of interrelationships. As a result, affiliate company organizations have become common way of doing business both in the financial and non financial sector of the economy. It is also likely that the formation of business groups will further expand to survive and become more competitive in the market.[156]

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[154] Data Base Kept at Ministry of Trade and Industry, Commercial Registration and Licensing Directorate.
[155] Ibid.
[156] Dr. Alemayehu Geda, The Road to Private Sector Led Economic Growth, A strategy Document AACCSA, Sida, 2009, P. 106

As observed from the collected data, except the banking and insurance companies, in most other group of companies considered affiliation are among private limited companies.

To analyze the organizational structure of affiliate companies in Ethiopia one has to exhaustively see as much as possible the affiliate groups in the country. But apart from the time and resource limitation, the lack of official system to identify companies as affiliate or unaffiliated makes it is difficult to know the extent of affiliate companies present in the country. The official in charge of company registration and licensing at the Ministry of Trade and Industry does not know officially which of the companies are affiliated, which of the companies are registered as parent and subsidiary. All the companies registered at the Ministry are separately registered as a company in themselves and unless you go and check the file and documents of each and every company it is not easy, the official said, to know which companies are related or not.[157] So, it is left for the writer to check each and every file of the companies' registration which is time consuming for the writer and the officials in charge, to go through all the files of registration of individual companies at the Ministry. So because of time and resource as well as the necessity to make a limit to the research those companies registered at the Ministry of Trade and Industry are made the domain for the selection of sample together with the financial companies regulated under the authority of National Bank of Ethiopia. Generally the following groups are considered in the study:-

- MIDROC Ethiopia Group with more than 32 member companies under it,
- Effort endowment companies consisting more of than 12 companies,
- DH Geda group consisting more than 8 companies,
- Kangaro group consisting more than 8 companies,
- Negat International P.L.C., Tracon Trading P.L.C and Three Brothers P.L.C
- Dire group consisting more than 2 companies,
- Awash International Bank and Awash Insurance
- Dashin Bank and Nyala Insurance
- United Bank and United Insurance
- NIB Bank and NIB Insurance
- Abyssinia Bank and Nile Insurance
- Wegagen Bank and Africa Insurance

[157] Interview with Nuredin Mohamed Ibrahim, Director of Trade Registration and Licensing Directorate, Ministry of Trade and Industry, held on 24 Nov. 2009

3.1.2. Basis of Affiliation of Companies in Ethiopia

A. Dominant share holding by an individual in more than one company

Out of the non-financial companies considered MIDROC Ethiopia groups, DH Geda Company groups, kangaroo groups are tied together by one individual holding the majority of share capital of the companies in the group in the following manner: In MIDROC Group, sheik Mohammed Hussein Ali Al Amoudi personally holds 70% in National Mining Corporation, Elfora Agro-Industry, Huda Real Estate, Modern Building Industry and MIDROC Construction PLC; 60% of share capital in MIDROC Gold Mine PLC and Summit engineered plastics PLC; 75% in Moha Soft Drinks Share company; 80% in the newly established Derba MIDROC Cement Factory with a capital of half a Billion (500,000,000) and the newly acquired Unity University PLC and 50% in Kombolcha steel Products Industry (KOSPI).[158] These companies are only some of the member companies of MIDROC Ethiopia group which has more than 32 (thirty two) legally established companies.[159] The groups as the brain child of Sheik Mohammed Hussein Ali Al-Amoudi, are under his dominant or majour ownership. As owner and chairman of MIDROC Group, has to-date made investments with the fund of over USD two billion in almost all sector of the economy, (Hotel and tourism, agriculture and Agro-industry, construction and mining, manufacturing, healthcare, trade and commerce, education and training, air transport and real Estate businesses).[160] So in MIDROC Ethiopia Group affiliate companies, the dominant ownership by one individual is one of the strong basis of affiliation.

In the Kangaro business groups, Ato Yirga Hayile owns 70% of share capital in Kangaroo Plastics and Batu Tannery PLC, 75% in Kangaroo shoe and Kangaroo foam companies, who as major shareholder is also the manager of these company groups.[161]In the DH Geda Group of Companies, Ato Dhuguma Hunde Geda used to own 98% of

[158] The Companies Registration file or document kept at the Ministry of Trade and Industry, Reg. No.No./AA/pc/1/0008/88,EIA/pc/01/0069/90, EIA/pc/01/0066/90, MOTI/pc/1/0006/87, EIA/pc/01/0015/88, MOTI/pc/0149/95, EIC/pc/01/0141/99, EIA/pc/01/0003/88, EIA/pc/01/1071/06, 020/2/6164/2001, EIE/pc/1/0017/88 respectively.

[159] TIRET- MIDROC Ethiopia Investment Group, Special Millennium Issue Sept. 2007 P. 6

[160] Ibid. PP. 5-6

[161] Supra note 158 Reg.No.06/2/3273/96, AA//pc//2/429/84,AA/pc/1/242/82 and AA/pc/1/242/82 respectively.

Share Capital in the DH Geda Blanket Factory PLC, 90% of the share capital of the DH Geda Batrie and DH Geda Trade and Industry Private Limited Company, 80% in DH Geda G.I. Sheet Factory PLC, who was the owner and General Manger of DH Geda Company groups.[162] So his majority ownership in the member companies is the basis of affiliation between the companies.

B. Family Relation

Group affiliated business may also be made through family or social relation. In the case of MIDROC Ethiopia, Sheik Mohammed Huseein Ali Al-Amoudi being the dominant shareholder in most of the member companies; the remaining shareholders are his brothers or another member company.[163] Not only that, some companies like trust protection and personnel PLC, Addis Home Depot PLC, National Motors PLC, Addis Gas and Plastics PLC, and Rainbow Travel PLc are established by the brothers of Sheiki Mohammed Hussein Ali Al-Amoudi without his membership or share holding in these companies.[164] Still these companies are declared to be members or affiliate of MIDROC Ethiopia Group and are managed as such.[165] MIDROC Ethiopia is also complex as the groups declare Dashin Bank and Nyala Insurance as their banker and insurer, and three brothers of Sheik Mohamed H. Al Amoudi are majority owners in these financial companies.[166] The family relationship is also found out to be the basis of affiliation in this case. In Kangaroo, DH Geda and Dire Company groups are also tied by the family relationship between the dominant shareholder and the remaining minority shareholders.[167] Nejat International, Tracon Trading and Three Brothers PLC are companies formed between family members (a father, mother, brothers and sisters).[168]

[162] Ibid. Reg.No.AA/pc/9/3007/91, AA/pc/4/01263/94, AA/pc/2/1073/85, AA/pc/7/2467/85respectively
[163] Supra note 158
[164] Ibid,Reg.No.MOIT/pc/01173/95,AA/pc/2/711/85, 020/2/2005/97,MOIT/pc/0059/91 respectively
[165] MIDROK News Letter abi monthly publication of the office of chief executive officer Vol. 9 issue 50 2008, see also Supra note 159
[166] Ibid, Data base at the National Bank of Ethiopia, Supervision Dept.
[167] Supra note 161,162 and for Dire groups Reg.No.AA/pc/2/634/84,020/2/1739/96.
[168] Supra note 158 Reg.No.AA/pc/3/1661/87, MOTI/pc/00990/94, AA/pc/72367/87 respectively.

C. Common management/board members

Common management of affiliate companies is a situation where two or more companies in a given group are managed by the same person or body of persons. In the non financial companies, considered as many of them are private limited companies, two or more companies in a groups considered are under the direct management of the dominant owner. In the case of MIDROC Ethiopia, about sixteen member companies are organized under the central management of the chief executive officer which in turn is under the chairman ship of the owner sheik Mohammed Hussien Ali -Amoudi.[169] Among MIDROC affiliate groups which are organized under office of Chef Executive Officer are, MIDROC Gold Mine PLC, Elfora Agro-industry PLC, Huda Real Estate PLC, Modern Building Industries PLC, Kombolcha Steal Products Industry PLC, Trust Protection and Personnel PLC, Addis Home Depot PLC, Trans Nation Air Ways PLC, Addis Gas and Plastics Factory PLC, Wanza Furnishing Industry PLC, Summit Engineered Plastics PLC, Rainbow Exclusive Car Rental and Tour Service PLC, Unity University PLC.[170] These companies are under common management at head quarter level.

In the case of DH Geda and Kangaroo Groups, the dominant owner identified above is also the general manager of member companies i.e. they are under common management too.[171]In the financial companies board members of Bank and the affiliate insurance company almost used to be common. i.e. there used to be interlocking directors in the affiliate companies.[172] Still as cross shareholding exists between them, sister bank and insurance companies are directors in each others board of directors.[173]

D. Common Shareholders

From the interview conducted with National Bank, private Bank and Insurance officers, in the financial companies considered in the study, it is observed that the founding

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[169] Supra note 165

[170] Ibid at 32.

[171] Supra note 161,162

[172] Interview with Kibire Mogos Manager, Legal department National Bank of Ethiopia on December 12, 2009

[173] Interview with Fasil Asnake, Manager, Legal department united insurance, and with Shifaraw Basha, Manager, Finance and Administration department of Awash Insurance, Asaminaw Bereda, Director of NIB International Bank and practicing lawyer on 25 Nov. 2009

members of private bank and the corresponding affiliate insurance company are common.[174] It means these shareholders who decided to establish private bank has decided to found a sister insurance company. These are to trap, insurance business that may arise out of banking transaction. When the bank gives loan to its customer it will take collateral as a real security for the performance of the loan obligation. The property may need to be insured particularity when its exposed to risk like vehicles. In these cases, the customers of the bank loan agreement will bring insurance policy for the property or other right from the sister insurance company. As a result almost all the shareholders of private bank are shareholders of corresponding sister insurance company.[175]

But this does not mean all the shareholders are common along the companies, as there could be shareholders which are not common between the bank and insurance company. Common shareholder is also the characteristics of non financial companies considered. One dominant owner and other family members are similarly owners in another affiliate member companies of the groups considered.

E. Cross shareholding

In the non financial companies, cross holding of shares between member companies in a group is not observed. But, the owning of shares of one member company by another member is common. For instance MIDROC construction PLC owns 50% equity in Wanza Furnishing Industry, and 30% in Huda Real Estate and Elfora Agro Industry PLC, but these companies do not reciprocally owns share in MIDROC construction PLC as the share holders of the latter are only Sheik Mohammed H. Ali Al Amoudi and Sofia Salah Munaser Al-Amoudi.[176] Guna Trading holds 75% share capital in Trans Ethiopia while the latter holds 1% share capital in the former.[177] Effort endowment groups are also involved in network affiliation with one company holding the share of another sometime without joint holding and further its holding of equity in bank and insurance, Wegagen and Africa.[178]

[174] Ibid, Supra note 172
[175] Ibid.
[176] Supra note 158
[177] Ibid Reg. No.04/2/3946/96 and Mk/pc/1/00007/85 respectively.
[178] Ibid, Data base at the National Bank of Ethiopia, Supervision Dept

In most of financial companies, there is cross holding between bank and corresponding insurance company. The percentage of cross holding as expressed in the financial statement reported to National Bank of Ethiopia the year 2001 is as follows: Dashin Bank has 16% share holding in Nyala Insurance conversely the insurance has 4% holding in the Bank. Awash Bank has 8.4% shareholding in Awash Insurance while the insurance has 5% shareholding in the Bank. United Bank holds 1.1% in united insurance while the latter hold 9% in the former and, in a like manner, each group of companies are tied by cross shareholding. The percentage of NIB Insurance in the NIB Bank Africa insurance in the Wegaen Bank and Nile insurance in the Absiniya Bank is also reported to be7%, 6%, 9%, and 15% respectively.

3.2. Legal framework of Affiliate Company in Ethiopia

3.2.1. Plurality of the Legal Framework

The experience of other countries had shown us that corporate affiliation raises special problem that needs extra regulation beyond tradition general company law. As a result, different countries have attempted to regulate corporate affiliation in different ways. On the one hand some, civil law countries had came up with a special body of rules dealing with corporate groups. In this regard the only country that had a comprehensive special regime from company law perspective for corporate groups is Germany and some other countries of the civil law system like Portugal and Italy had followed its trend to have such a law as part of their company law reform.[179] Even in such countries, other branch of law and piercing corporate veil doctrine serves functional equivalence in corporate group situation.

On the other hand, common law countries had judicially entertained the problem of affiliate company by making exception to the principle of limited liability (i.e. piercing the veil doctrine) and latter on, issued statutes that addressed affiliation among

[179] Supra note 87 at 84

companies.[180] So, the approach to affiliate companies problem have been various and, it is also addressed through plural regulation in different branches of law.

Though Ethiopia's legal system does not belong to the common law legal system, its company law is influenced by both the common law legal system and civil law legal system. In the legislative background document the drafter of Commercial Code of Ethiopia noted that

> *The goal to attain is to encourage one day the investment of Ethiopia savings in large, broad-based enterprises with out at the same time discouraging the contribution of foreign capital. This is why without taking into account the so called preference to be given to this or that model in the continental or Anglo American Legal system, I have always in mind the interest of Ethiopia and I have selected the solutions which I believe to be the best no matter where they come from . . .* [181]

So, one would be at crossroads of different regulatory approaches adopted by the common law countries and civil law countries to clearly ascertain an aspect of Ethiopia corporate group law or regulatory framework of affiliated group of companies in Ethiopia. It could not be easy to identify the approach the country had followed with regard to affiliate company problems. Some of the rules are included from common law countries, other from civil law countries.

On the one hand, in common law countries, statutory regulation of affiliated group of companies is uncommon. Rather corporate group law is emerging in these countries from the judicial practice of piercing the veil doctrine. The common law regulatory model of company in general and company groups in particular is shaped on the contractarian corporate law principle that holds corporate law to be standard form for most firms and

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[180] Supra Chapter two at 34-37

[181] Winiship P. (Editor and Translator) Winship. Background Document of Ethiopian Commercial Code of 1960. (1972) Faculty of Law, Haile Selassie I University Artistic Printers Addis Ababa Ethiopia P. 61

the remaining firms has to tailor the contract to their specific situation.[182] For them, since corporations are creations of private contracts, the emphasis is in minimizing agency problem between owners and managers (which results from separation of ownership and management in large firms) through rules on fiduciary duties of management and information disclosure.[183] Legal regulation of corporate group is not the typical of common law countries.[184]

On the other hand, the civil law countries view corporation law from stakeholder perspective and corporation as social institution encompassing the interest of wide range of groups; investors, employees, suppliers, customers and managers giving precedence to protection of those dealing with corporation.[185] In spite of such a view of corporation law, civil law countries themselves are not uniform in having special regime on affiliate companies and it is from time to time that law for group of companies is emerging.

In such circumstances, it is not surprising for Ethiopia not having a special regime governing company groups or clearly identified rules on affiliate companies. At the time when Commercial Code was enacted in 1960 affiliate company structure and problem specific to the group was less familiar to other legal systems that influenced in the enactment of the code.

Further when the Commercial Code was enacted, the question was to have "large and broad based enterprises" established in Ethiopia and that was to be encouraged.[186] The problem of complex corporate affiliation and integration was not in order at that time. This is not to defend the lack of law dealing with corporate group in Ethiopia, rather how difficult to have one in Ethiopian context then and now even. At present, since company affiliation and grouping are becoming common in the country, the issue of regulating such economic reality should not be left any more to obscurity.

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[182] Mark J. Roe, "Some Differences in corporate structure in German, Japan and United States" in Yale Law Journal. 1993 Vol. 102 P. 1933
[183] Ibid.
[184] Supra not 87 at 82
[185] Ibid.
[186] Supra note 181.

So, as will be seen subsequently, even if there is no enough and clear rules on affiliate companies in Ethiopia company law, certain specific rules in other branches of law like bankruptcy law, financial market regulation laws and others could be taken as part of the legal framework for affiliate companies. That is to say, even if there is no special regime governing Affiliate Company in Ethiopia, there are provisions here and there in different branches of law that one way or another has application to affiliate company situation. So, unless company law and other branch of law are considered full picture of affiliate company regulation currently existing in Ethiopia could not be obtained as a result the rules to be considered are not limited to company law.

3.2.2. Specific Rules Pertaining to affiliate company regulation

So, far we have seen that corporate group laws, even for the most advanced economies, are scanty and immature. For some countries as in common law, it is emerging from judicial piercing the veil doctrine which itself is "enveloped in the mists of metaphor" i.e. not easily discernible.[187] In the face of growing importance of affiliate companies as an entrepreneurial reality in Ethiopia, it is timely to search and research the availability of legal framework for regulating affiliate company in Ethiopia. The following rules in different branch of law are considered to be such framework apart from company law rules on the protection of creditors and minority share holders discussed in another research, such as rules on maintenance of capital.[188]

A. Rules on Joint Holding

Cross holding between two or more companies occurs when one company subscribes share of another company and in return that other company also purchases shares of its member company.[189] Rules on acquisition of share between companies are to be found

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[187] Lee Handel CH and Blumental David, "Parent Company and Shareholder Liability: Piercing the Viel of Chinese Corporate Subsidiaries Business Law International Vol. 5 No. 2 2004 P. 229

[188] Yitayal Mokonin Legal and Institutional framework for Regulating corporate groups in Ethiopia 2008 (un published); A.A.U, Law Faculty PP. 66-83. To mention some of the minority rights under our law are; right to be represented by at least one representative on the board of directors(Comm. Code Art.352), prohibition of shares with different classes as to voting rights(Comm.Code Art.336(2),407, right of withdrawal (exit right)for dissenters against payment of fair price(Comm. Code Art.463,545), to request investigation by MOTI in to the affairs of the company(Comm. Code Art.381) etc.

[189] Supra note 43 at 42

mainly in company law on joint holding and in the banking regulation of limitation on share acquisition. The company law restriction on cross holding or joint holding of shares between two or more companies is not a total bar of cross holding, rather it is restriction to a certain percentage level.

Cross holding of shares have two consequences;[190] first evasion of minimum capital requirement necessary for the formation of a company. In this case, one company already formed meeting the legally required capital wants to promote another company by subscribing most of the shares, in return the new company after its formation buys most of the shares of the former company returning its money back.[191] This amounts to a company acquiring its own share, which is allowed only exceptionally.[192]

> *If a company A holds share in company B which in turn holds share in company A, it is clear that basic principle governing the raising and preservation of capital are threatened. By engaging in reciprocal share holding, company A comes to hold shares in itself by virtue of holding shares in company B. The result is that the stated capital of both A and B may be regarded as partly fictional.*[193]

Second, one of the companies involved in joint holding may usually hold majority share in the other company which can lead to a situation in which one company become dependent on another affecting creditors of such companies. Dependant relationship between companies in a group is one of the most condition that triggers inter-corporate liability. Recognizing such effect of cross holding, the Ethiopia commercial code on company law restricted cross holding of shares only to 10% percent each. The text of the provision is important:-

Art 344

1) *Where ten percent or more of the capital of one company is held by a second company, the first company may not hold shares in the second company.*

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[190] Ibid.
[191] Ibid.
[192] The Commercial Code of the Empire of Ethiopia Proclamation No. 166/1960, Negarit Gazeta, Year 19, No. 3, Addis Ababa, 5th May 1960. (to be cited hereinafter as Commercial Code) Art. 332
[193] Supra note 43 at 42

2) *Where two companies each have a capital holding in the other company and one of such holding is ten percent or more of the capital, the companies shall declare their holdings to the Ministry of Commerce and Industry which shall require the companies by agreement to reduce their holdings so as to conform to the provision of sub-art (1). If the companies fail to agree, the Ministry of Commerce and Industry shall order the company possessing the smaller holding to dispose of that holding.*
3) *Where the respective holding are equal, and failing one company disposing of its shares in the other, each company shall reduce its holding to less than ten percent of the capital of the other.*
4) *The companies shall furnish to the Ministry of commerce and industry a sworn statement that they have complied with eithes sub-art (2) or sub-art(3) of this Article.*

The implication of the above provision is manifold. First crossholding is permitted in Ethiopia within the legal limit. Many companies could form a group by holding each others share to the extent of 10% but not equal to 10% or more. Affiliation among companies could be based on the joint holding of shares with in such legally prescribed minimum. Second, one company could own the share of other company to the extent of majority ownership with out however wholly owning it. So, under Ethiopia law there is a possibility of parent - subsidiary company. But wholly owned subsidiary is not possible in Ethiopia context because one man company is not yet recognized under Ethiopian law.

Further, the possibility of establishing holding company, in the sense it is established merely for owning stock in other companies and supervising their management is arguable under Ethiopia law. If such activity of holding company is deemed to be an economic activity under Art. 5 of the Commercial Code, there is no reason why it should not be established. Most of the time, it is the anti-monopoly legislations and the doctrine of ultra-virus that prohibits the operation of holding company in other jurisdiction.[194]

[194] Supra note. 57 at 233

There are number of question that may be raised here: what if in spite of the restriction, the companies are found to be involved in mutual holding of shares beyond threshold level? Could the requirements of disclosure and divesture be effective in practice? Further even if companies do not contravene the rule on joint holding, the possible dominance in the shareholding of one company over the other and there by influence or control in the management could also give raise to contention. If issue of liability for creditors' action is brought to court, could one company be liable for the debt of other company both of which are cross holding shares beyond the legally acceptable level? Still the rule on cross holding does not address these problems. Even when the companies disclose their joint holding, there is no time limit with in which they could make it right. Further, no consequence is attached for non compliance under the law.

B) Rules on Limitation of acquisition of banking and insurance company shares

The extent to which any person, an individual or a company, could hold the share capital of any private bank is not left for the choice and convince of the companies concerned. It is subjected to strict regulation. It is a new legal development as under the former banking supervision proclamation, the extent of shareholding in bank by other person was not addressed. On the other hand the extent of investment by banking company in other insurance company or other business activities was regulated in such a way that a bank may establish an insurance company, real estate developer, or other single non banking company by subscribing up to 20% of the share capital of the new company.[195] As stated above, other companies holding in such bank was not formerly regulated, i.e. cross shareholding was not specifically addressed, in which case the general provision on joint holding of companies above may apply. To fill this gap and to fit in to the special problem in financial companies, it is provided that a person other than Federal government of Ethiopia may not hold more than five percent of total equity capital of any private bank.[196] Not only that, if any one person own or holding more than 2% (two

[195] National Bank of Ethiopia, DIRECTIVE No. SBB/12/1996 Limitation on Investment of Banks issued pursuant to authority vested in it by Art. 36 of Licensing and Supervision of Banking business proclamation No. 84/94

[196] FDRE, Banking Business Proclamation No. 592/2008 Federal Negarit Gazeta Year 14 No. 57 Art.11(1)

percent) of share capital of any given banking company; it he/she may not hold a share in other banking company.[197]

Formerly an insurance company may be affiliated with another banking company by owning up to 15% share capital of that other company,[198] however if, that other company is a bank, presently it could only hold a share up to 5% (five percent).[199] i.e. under the present legislation an insurance company could hold shares in sister bank up to 5% and the bank may hold up to 20% in respective insurance.[200] So, there is possibility of joint holding even when one company holds more than ten percent in another company. This could be compared with the legal scheme provided under the Commercial Code of Ethiopia the Minimum of which is less than ten percent each.

What are the consequences from the perspective of the regulator or those who might have been affected? If the bank has violated the limitation on the acquisition of share, the National bank of Ethiopia may takeover the concerned bank and put it under receivership.[201] But then what if question of liability as between the bank and some other company acquiring share above the minimum level? Could the creditor of the bank, its shareholders or others or the vise versa (which have been affected as a result of other company having intolerable ownership in the bank) reach the asset of one company for the performance of other company obligation? (say at time of insolvency). This is an issue of inter-corporate liability, which matters most in the law of affiliated group of companies. As a financial regulation the proclamation on the banking business does not address the details of such issues and problems. It is a gap that one faces when the problem materializes. In any case it is submitted that, these set of rules on share acquisition in both company law and financial regulation law forms part of Ethiopia's affiliate company legal framework.

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[197] Ibid. Art. 11(4)

[198] National Bank of Ethiopia, DIRECTIVE No. S1B/25/2004 issued pursuant to authority vested in it by Art. 14(1) of Licensing and Supervision of Insurance business proclamation No. 86/1994

[199] Supra note 196

[200] Supra not 195.

[201] Supra note 196 Art. 33(1)

C. **Consolidated Account**

Under U.K company law, when companies operate together as a group a fairer picture of the financial health of the enterprise as a whole needs to be given by preparation of consolidated account or group account,[202] which influenced the same provision to be included under Ethiopian commercial code.[203] Under the organizational structure section, the existence of affiliated companies having various interconnection like dominant individuals shareholder, family ownership and control, common management, cross shareholding and interlocking directors have been indicated. The existence of parent subsidiary relationship is to be a legal possibility found out.

So, whether the duty to prepare group account under Ethiopia company law is applicable to all groups considered in the study is doubtful as most of the non financial affiliate companies considered are private limited companies and most of them does not exhibit parent subsidiary relationship, where as the rule on consolidated account is provided under the provisions or section dealing with share companies and specifically mentioning parent or holding company and subsidiary company. What if the share company had a subsidiary in the form of private limited company, does the parent company have to prepare group account? It is not clear.

In any case, holding (parent) company is under the duty to prepare group account as provided under Art 45I of the Ethiopian commercial code.

1. *Where a company is a holding company, the account of its subsidiaries shall be submitted to the annual general meeting at the same time and in the same manner as its own account.*
2. *A consolidated balance sheet and profit and loss account shall be prepared in respect of the holding company and its subsidiaries.*
3. *The provision of sub art (2) shall not apply where the directors are of opinion that the drawing up of such balance sheet would be impracticable or too onerous or of little concern to the shareholders on account of the small financial interests involved.*

[202] Supra note 31 at 137
[203] Supra note 181

4. *The provision of sub art (2) shall not apply if the Ministry of Commerce and Industry approves, where the directors of the holding company are of opinion that the drawing up of such balance sheet could prejudice the company or its subsidiaries or that the company and its subsidiaries carry out business of such a differing nature that they may not reasonably be deemed to form a single enterprise.*

The implication of this rule from the context of affiliate company regulation is manifold, first from the absence of legal requirement as to publicity of affiliation or grouping structure at the formation, registration or licensing stage, what is the mechanism to enforce the requirement of joint annual financial reporting which appears to be mandatory?

This as it may, the other implication is that, the preparation of joint financial reporting serves important source of information as to the operation of the business, management and performance of the group as a whole particularly from the context of minority share holders and creditors of the member companies in the group. Financial reporting has as its function a form of monitoring for the benefit of shareholders, creditors and others interested.[204]

Reporting implies accountability. So, there is a room for the accountability of holding or parent company for poor performance of the subsidiaries as could be implied from the joint financial reporting requirement. At least the holding company or parent has to comment in the report the reasons why a given subsidiary company is doing or performing in a certain way.

> *The original purpose of accounting is to account - that is to show how money and property entrusted to an agent had been used so that the principal could be assured that the agent had acted for the principals benefit rather than the agents.*[205]

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[204] Mahoney Paul G. "Mandatory disclosure as a solution to Agency Problem" in University of Chicago Law Review, 1995, Vol. 62 P. 1085

[205] Ibid.

Moreover, the power of an auditor of the holding company or parent company to have access to the books, documents and accounts of the subsidiary,[206] and latter disclosure is important to uncover breaches of managements duty to make way for the liability of holding or parent company to share holders (minority) or creditors of subsidiary company.

D. Rules on Liability of directors, officers and manager

Board of directors is a compulsory management organ for share companies while it is not for private limited companies. When a given company is to be managed by board of directors as a matter of law, the numbers of members are between 3 and 12 (not less than three or more than twelve).[207] When one company is a shareholder in another company, as a shareholder that company may be a board member, but as a corporate body it will not be chairman of the board[208] and what is the implication of one company becoming director in another company particularly with respect to duty of directors? What if directors of the two companies are the same person (common directors)?

"It is worth noting that the chairman of the board must be a person, although body corporate could be member of the board. The implication of this with regard to legal liability of the board and board members is something to contend with, particularly when the board member is a corporate body and is itself an affiliate company, such as when a bank is a board member of an affiliate insurance company or vise versa."[209] That is to say a company appointed as director in its affiliate company may entail liability for familiar of duty as a director.

In a single company situation it is clear that a body corporate which is a director in another company will be liable to the company in which it is a director, to the shareholders of the company or creditors of the company when it fails in the duties

[206] Commercial Code Art. 379
[207] Ibid. Art. 347(2)
[208] Ibid. Art. 348(4)
[209] Johanner Kinfu, "The Provisions of the commercial code of Ethiopia (1960) on the Governance of share companies (corporations) in Ethiopia". Ethiopia Journal of Accounting and Finance, 2006 Vol. 1 No. 2 PP. 64-65

imposed by law or laid in the memorandum/article of association.[210] In Ethiopia directors as an agent are required to act with due care, particularly to keep regular records of management and of meeting, keeping accounts and books, submitting accounts to auditors and annual report to the meetings, convene general meeting without delay where three quarters of capital are lost, set up the reserve funds, applying to court where the company stops payment.[211] These duties require attention i.e. care and diligence.

Further, under the Ethiopian Commercial Code, the duty of loyalty[212] is provided by way of restriction on self dealing transaction and total prohibition of loan contract between the director and company.[213] Self dealing transaction could not be totally banned, an alternative is to have an independent directors. But in Ethiopia context, companies are not required to have independent directors.[214] The option is to approve such transaction by board of directors and special report to the general meeting of such transaction by auditor.[215]

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[210] Commercial Code Art. 364-366, The duty of care and diligence consists in the duty to pay attention and try to make good decisions. But what is good decision? Who is to judge that? In common law countries there is a doctrine of business judgment rule that precludes courts from second guessing i.e. substituting their business judgment for that of the corporations manager. Under the rule, corporate managers and directors should not be liable in court for unwise decisions; when the decision is informed one, have no conflict of interest and has a rational basis. It is said directors and officers not shareholders and the court are best able to make business judgments. See Supra note 141 at 956

[211] Commercial code. Art. 362

[212] The duty of loyalty consists in duty not to self-deal, not to usurp corporation opportunity, not to oppress minority shareholders and not to trade on inside information. It is the duty which requires the decision makers to act in the interest of the company and not in heir own interest i.e. self dealing. Self dealing is either direct or indirect which generally involve transactions with the company and director, his/her relative or second company that the director controls. See Supra note 141 at 965-966, see also Black, Bernard S. "Legal and Institutional Percondition for strong security market" in University of California law Review 2001 Vol. 48.P.804

[213] Commercial code Art. 356, 357

[214] Ibid. Art. 347(1)

[215] Ibid. Art 356,

Moreover, if a single person is a director in two or more affiliate companies or board members are common in both companies, then the issue of common board membership may arise. It is the way to centralize the management of affiliate companies i.e. two or more affiliate companies being under common management. Further, it may be difficult for the directors common to both the companies to reconcile, the interest of the companies in which he/she is a director as a result of the conflict of interest situation. Not only that, duty of care and diligence may also be at risk in such circumstance. When person with dual directorships approve transaction between the parent and the subsidiary, there may be no arms length bargaining.[216]

> *Conglomerates have a hard time finding directors who have no interest that conflict with companies' diverse interests; while it is the duty of director to keep a breast of his company's operation it is impossible for any one to keep a breast of a conglomerate.*[217]

Moreover the relation of directors to corporations is of such fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation and where the fairness of such transactions is challenged the burden is up on those who would maintain them to show their entire fairness.[218]

The Commercial Code and previous banking proclamation are silent on this point and as a result, board members of sister insurance company is also a member of board of directors of corresponding sister or affiliate bank. However the new banking regulation had recently adopt a rule that forbid common board membership as follows; [219]

3. *A director or chief executive officer of a financial institution may not, at the same time; serve as a director of a bank. Moreover a business entity or a company in which such director or chief executive officer has ten percent or more equity interest may not serve as a director of a bank.*

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[216] Supra note 141 P. 966

[217] Knepper William E, Liability of Corporate Officers and Directors 1969 (The Allen Smith Company Indiana) P. 72

[218] Ibid. p. 43

[219] Supra note 196 Art. 15(3)(4)

4. *An employee of a bank may not be a chair person of the board of directors of that bank or director of any other bank.*

Notice, two banks may not be allowed to have common board members or management. Further, the offices of board directors and that of officers is not allowed to be headed by one person. That is, a Chief Executive Officer of a bank may not be chairperson of the board but a director could be an officer and the vise versa. Where as in the Commercial Code, an officer of a company is not allowed to be member of board of directors and that is the rule for non financial companies at present.[220]

The Commercial Code rules on the liability of directors and officers are primarily meant to govern the responsibility of directors and officers in a single company model. However since affiliate company structures are permissible under the law, we have to apply it to group of company's. These rules on the director liability forms very important part of affiliated group of companies regulation. First, in an affiliate company relationship a member company which is also a director in another member company may be liable as a director depending on the circumstance for that other company, the minority shareholders and for creditor of that other company for failure of duty. In the case of liability to the company, the parent company which is a director in the subsidiary may cause damage to the interest of the latter. In that case there is a way for the liability of the parent for the subsidiary company.

Art. 364 - Liability of directors to the company

1) *Directors shall be responsible for exercising the duties imposed on them by law, the memorandum or articles of association and resolutions of meetings, with the care due from an agent.*
2) *Directors shall be jointly and severally liable to the company for damage caused by failure to carry out their duties.*

[220] Commercial Code Art. 348(4)

3) *Directors who are jointly and severally liable shall have a general duty to act with due care in relation to the general management.*
4) *Directors shall be jointly and severally liable when they fail to take all steps within their power to prevent or to mitigate acts prejudicial to the company which are within their knowledge.*
5) *Directors shall be responsible for showing that they have exercised due care and diligence.*
6) *A director shall not be liable where he is not at fault and has caused a minute dissenting from the action which has been taken by the board to be entered forthwith in the directors' minute book and sent to the auditors.*

Second, what makes directors liability rule very important is minority shareholders could have direct action against the director company. For instance minority shareholder of subsidiary company could directly sue the parent (director) for the damage caused to their interests in the subsidiary company individually or in class action. Particularly the provision of Art. 365(4) address the protection of minority interest with respect to duty and liability of directors. But the minorities in this case needs to be 20% block holders in equity capital of the company if it is less than that the protection does not apply.

Art. 365 - Proceedings to enforce directors' liability

1) *No proceedings shall be instituted against the directors without a resolution of a general meeting to this effect. Such a resolution may be moved and adopted although not on the agenda.*
2) *Where a resolution to institute proceedings or to compromise the claim is adopted by a vote of shareholders representing at least one fifth of the capital, the director concerned shall be removed. The same meeting shall appoint a director to replace the director who has been removed.*
3) *A resolution not to institute proceedings and to compromise shall not be adopted where shareholders representing one fifth of the capital vote against the resolution.*

4) *Where a resolution under sub-art. (2) is adopted but the company fails to institute proceedings within three months, the shareholders who voted for the resolution may jointly institute proceedings.*

Thirdly a parent company or another which is appointed as a director in other member company in affiliate relation may be liable for the creditors of the subsidiary or other company controlled or dominated if the company fails to meet its obligation. This is an important rule for inter-corporate liability or parent liability rule.

Art. 366. - Liability to creditors

1) *Directors shall be liable to the company's creditors where they fail to preserve intact the company's assets.*
2) *Proceedings may be instituted by the creditors against the directors where the company's assets are insufficient to meet its liabilities.*
3) *A resolution of the general meeting not to institute proceedings against the directors shall not affect the creditor's rights.*
4) *Creditors may not apply to set aside a resolution to compromise except on the grounds available to them under civil law.*

Finally, when it comes to the duty of manager in private limited companies, it has to be considered under the general legal scheme of private limited companies. Normally the safeguards required in the interest of public investor in the case of share companies are not provided for private limited companies.[221] Private limited companies are expected to be established between family members and close friends as invitation to public to contribute capital is prohibited and transfer of share is restricted. It does not however mean that the interest of minority shareholders and creditors are not in danger in such companies particularly when it involves affiliate company organizational structure.

It may be the case that, affiliate companies having private limited companies as their member falling under common management but operating as a separate legal entity. Not only that, some of the interviewees consulted by the writer who were working as attorney

[221] Gower C.B., The Principles of Modern Company Law, 1957 (London, Stevens & Son's Limited P. 13)

to some creditor bank replied "one individual could establishes as many private limited liability as the series of activity he/she could undertake in business while he/she could have done it under one. Sometime bank loan is given for one company but the money will be used for another affiliate company, and the creditor bank could not get its loan back because the company is not operational and there is no asset which the creditor could reach in the name of the company."[222] The other interviewee also added that, the health of the business of private limited companies in Ethiopia particularly in relation to credit worthiness as an organization is presently in question and, I will not as a practicing lawyer makes a professional contact with private limited companies without taking guarantee.[223] The behavior of private limited company from the perspective of creditors is requiring unlimited shareholder liability, though there does not seem any clear legal ground for doing so.[224]

In such cases one of the remedy provided under our company law is managers liability rule that the manager as an individual may be liable for the company or third party for breach of duty in the following manner:

> *In accordance with civil law managers shall be liable individually or jointly and severally as the case may be to the company and third party for any breach of their duties under this code or the article of association.*[225]

However, since the management is run on individual capacity not as corporate body as in the case of management of share companies by corporate body, inter-corporate liability based on directors, officers or manager liability rule is of minimal use. Further it is not clear under this rule whether the liability of manager of private limited company for creditors of the company, could be extended to another affiliate company asset. This point is to be discussed under the rule that follow, adjudication of bankruptcy in common.

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[222] Interview with Ato Bayisa Olana and Zenebe Asfa former Federal first instance court judges and latter attorney of commercial bank of Ethiopia, presently practicing lawyer, on November 23/2009

[223] Interview with Ato Bashada Gemechu, former Oromiya Supreme court president and presently practicing lawyer, on November 25/2009

[224] Interview with Ato Endakemew Getnet, Commercial Bank of Ethiopia, Manager of Forclousure and Litigation Division, on November 25/2009

[225] Commercial Code Art. 530

E. Adjudication of bankruptcy in common

Not every company justifies the confidence its original investors placed in it, as there is no guarantee that all capital will earn normal rate of return. In a world of change, where sure knowledge of the future is lacking and decisions are made under conditions of more or less uncertainty, the operation of any business is a calculated risk. As a business when any trades makes loss and become insolvent the legal way of exit from the activity is declaration of bankruptcy. This is the way for all traders whether an individual partnership or a company.

So as trades, companies under Ethiopian law are subjected to bankruptcy proceeding in the event of insolvency i.e. when their assets are insufficient to meet their liabilities.[226] What makes bankruptcy of companies different from that of partnerships is that in the former bankruptcy of company does not cause bankruptcy of shareholders, while bankruptcy of partnerships cause bankruptcy of partners.[227] This is based on the principle that shareholders are not liable for the debt of the company even when it is insolvent. But this principle is not always without exception. The rule on adjudication of bankruptcy in common is one such exception that could pave a way for inter-corporate or liability as shareholder.

As discussed before affiliate companies, though they are legally separate, interrelate in many ways. The interrelationship among other things consists in common business ownership, majority stock ownership of one company in another affiliate company, common and dominant individual ownership in more than one company, common management of the affiliate companies or without having common formal management, the influence of one company in the management of other member company and the like. Depending in such factual relationships, one company may be appointed as a director of another affiliate company. This is the case in financial affiliate companies where an insurance company will be appointed as director in the affiliate bank and the vise versa. Further, it is also possible for many affiliated group of companies to fall under common

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[226] Commercial Code Art. 968, 1155
[227] Commercial. Code Art. 1158, 1163

management as the case with MIDROC Ethiopia Technology Group where out of more than thirty two companies in a group about sixteen affiliate companies fall under common management of the office of chief executive officer. Moreover the relationship of parent subsidiary in affiliated group of companies is best illustrative of the dominance or control of one company (the parent) through both stock ownership and managerial influence in its subsidiary company.

The shareholder of a company who while carrying out commercial operation in their capacity as directors, mangers of the company may dispose of the company's funds as though they were his/her own. This control and personal use of companies asset may result in the co-mingling of asset of the company with that of the shareholders. This means the members use the company as a cover not as true entity disposing its property in its own interest. If this happens in affiliated group of companies like the subsidiary is used by the parent company just as a cover to control and use the property of the former to advance its own interest than that of the subsidiary company, creditors of the subsidiary company may not be paid from the debtor company property, as the parent company has already commingled with its own property.

In such circumstances, what are the legal remedies available to those who are prejudiced by the operation? It is important to notice the provision of Art. 1160(1) the commercial code of Ethiopia which reads:

> *Where a share company or private limited company is declared bankrupt, the adjudication may declare bankrupt any person who has carried out commercial operations on his own behalf and disposed of company funds as through they were his own and concealed his activities under the cover of such company.*

Apart from the application of this provision to bankruptcy of unaffiliated company, it is important to notice the possible application of the provision to affiliate companies bankruptcy. That is, the provision has to be interpreted in light of the factual relationships in affiliate companies and in light of the following three conditions provided.

First the phrase “any person” above could be an individual person or a corporate body because corporate bodies are also person under the law. As we have seen that a corporate body could be appointed as a director of a company, as a director a company could carry out commercial operation of another company. Second, though the company as a director, while carrying out commercial operation, has a duty to act in the interest of the company in which it is a director, it will not always be the case as the director company may run the affairs of another company to fulfill its own interest. That is what is meant by “on his own behalf”. Thirdly the director or manager hides behind the corporate veil when it engages in transaction for his own benefit. So, if the parent company which is a director or manager in its subsidiary by appointment or without such appointment *(de facto)* had carried out the commercial operation of the subsidiary but drained the profit or the asset to the parent company to the detriment of the subsidiary company or its creditors, the adjudication of the bankruptcy of the subsidiary company should be extended to that of the parent company under Art. 1160 of the Commercial Code. This is an important device by which the dominant corporate shareholder can be held liable for the debt of company’s obligation and hence it is a rule of inter-corporate liability.

Sometimes, the affiliate companies are tied together by dominant individual shareholder who is the owner manager of the companies. If one of the company become insolvent and to be adjudicated bankrupt, the above conditions being fulfilled, the bankruptcy of the company could extend to the individual manager.[228] Alternatively if the companies are private limited company, the manager may be required to pay all or some of the debt of the insolvent company under 531 of the Commercial Code:

1. *Where in a bankruptcy the assets are shown to be in adequate, the court may on the application of the trustee in bankruptcy, order that the company’s debt or part of them shall be paid by the manager of member or by both or some of them with or without joint liability.*

[228] Commercial. Code Art. 1160

2. *An order under sub Art. (1) shall not be made in respect of members who have not acted as managers, nor shall it be made where the manager and members show that they have acted with due care and diligence.*

Under this provision the manager of private limited company is liable to creditors of the insolvent company without a need to extend bankruptcy proceeding of the company to the manager. The importance of this remedy is that, the three conditions of Art. 1160 discussed above need not be proved by the creditor in bankruptcy. So, for creditors of private limited company this is a preferable action, if the manager could be able to meet the demand. What if, failing to defend himself/herself under theory of due care and diligence, the manager has no asset in his own name but has another company in which he/she is major shareholder? Assume still that this other company has not involved in the management of the insolvent company, but it is the manager who appeared in the bankruptcy proceeding leaving the possibility for the attachment of the shares hold by the manager in the solvent company, could it (the solvent company) be liable for the debt of the insolvent affiliate company could the two companies be consolidated in bankruptcy or could Art. 1160 of Commercial Code be applicable particularly when the manager in carrying out commercial operation of the insolvent company had commingled the affairs of the affiliate companies?

The answer is in the affirmative. Creditors should be able to demand, as an alternative to manager liability rule, the consolidation in bankruptcy of the affiliate companies both of which are controlled by dominant owner manager. The absence of asset in the name of the manager while the debtor company is thrown away bankrupt, but operating other solvent company should be taken as the managers use of the cover of corporation to defraud creditors. Further, the lack of institutional control whether private limited companies have fulfilled, truly and in fact, the minimum required capital at time of formation and the absence of credible periodical audit system by itself is a practice against protection of creditors. Therefore creditors should be able to avail this remedy in bankruptcy.

Apart from declaration of bankruptcy in common creditors of one company in a group may have an action against other member companies of that group on the basis of transactions between affiliate companies prior to the insolvency of the debtor company.[229] For instance, if one of the companies has gratuitously transfers property, make gift or payments not due and similar transaction made in the suspect period (i.e. 6 months prior to bankruptcy) may be challenged by creditors in bankruptcy.[230] Even when due if payment is made by one company to the other affiliate after the date of suspension, creditors could also challenge the payment made.[231]

3.3. Inadequacy of the Legal Framework and the current practice

3.3.1. Inadequacy of the legal framework

In the preceding discussion it is demonstrated that affiliate companies are emerging in Ethiopia. The size and complexities in the organizational structure at least in some of the groups considered raises the question whether the exiting legal framework is sufficient to address problems inherent in such organization. The problems as considered before consists in the abuse of the benefit of incorporation to the determinant of those interests allied to the operation of the group, in particular liability toward creditors and adverse impact on minority shareholders etc.

It has been found out that Ethiopia does not have special regime for the regulation of affiliated group of companies. The lack of special regime however, does not imply affiliate companies are unknown to the legal system in Ethiopia Far from that. Some of the rules had been identified as a legal framework for affiliate companies in Ethiopia. The rules are plural in that they are found in company law, bankruptcy law and financial market laws. The rules may be classified into two: those dealing with formation, shareholding and financial reporting as group in affiliate companies on the one hand and those dealing with liability matters on the other hand. The first groups of rules are rules on joint holding or group of rules are rules on joint holding or restriction in share acquisition between group of companies and rules preparation and reporting of group

[229] Commercial Code. 1029-1031
[230] Ibid.
[231] Ibid.

account or consolidated account. The rules that are supposed to deal with liability matter are rules on the liability of directors, officers and manager of companies and rules on declaration of bankruptcy in common.

To come to the point at issue whether these rules are adequate or not, first rules on joint holding is important in avoiding evasion of capital requirement and maintenance, and possible domination of one company over the other. However the rule is found to be in adequate for the following reasons: one is that it does not specify effective means of disclosure of holding beyond legally prescribed minimum and it does not regulate the consequence of failure either to disclose or to comply with the rule after disclosure. The other reason is that these rules apply to share companies where as affiliate companies in Ethiopia are mainly in the form of private limited companies. The efficacy of rules on the limitation of acquisition of shares of bank to five percent is doubtful as some of the banks are characterized by large shareholding. But the rules if could be put to practice are important to control dominance.

Second, rules on consolidated account or group account as discussed so far provides for the preparation and reporting of financial information of a subsidiary and parent company jointly. Since the company law does not define holding, parent or subsidiary company, application of the rules lacks clear subject. Moreover, affiliate companies, as have been seen before, do not take parent subsidiary form alone. So, the rule is incomprehensive and unclear. Further affiliate companies in Ethiopia are mostly in the form of private limited companies where as the rule is meant to apply to share companies only. Finally, rules on group account is part of extensive disclosure requirement under common law corporate transparency tradition which is less familiar in civil law countries, likewise in Ethiopia there is no effective means of enforcing financial and other disclosure requirement of which group account is but one. Investigation by Ministry of Trade and Industry has significance just on paper.

Thirdly, rules on directors, officers and manager liability are discussed to form part of affiliate company legal framework. When a company is a shareholder in another company it could be appointed as director. In such case, the director company is expected to discharge the duties imposed on as director by law or memorandum or article of association. When it fail in that duty, the company will be liable as a director. This becomes important inter-corporate liability rule in affiliate company situation. As a director the company is liable to another company in affiliate relationship to its minority shareholders for damage and to its creditors for failure to preserve the companies asset intact in breach of duty of care or duty of loyalty.

However, the rules are inadequate as a framework prescribing inter-corporate liability matter as there is no mention of whether such provisions could apply to affiliate company situation or not. It is only by interpretation that the rules are supposed to apply. Moreover, the situation where a company, without being formally appointed as a director, has a dominating influence in the management of other affiliate company is not addressed under this rule. That is, one company may influence another affiliate company in the conduct of its business on the basis of majority holding in that other company. Directors liability rule do not help in such cases because there is no formal directorship.

Further, the liabilities of manager of private limited company for breach of duty do not serve as inter-corporate liability rule. It is difficult to reach the asset of one company for the debt of another private limited company on the basis of manager liability rule. In this regard the law is grossly inadequate to address the rampant abusive practice of establishing number of private limited company by one dominant shareholder without adequate capitalization.

Finally, rules on adjudication of bankruptcy in common are found to be forming the legal framework for affiliate companies in Ethiopia. But the rule does not clearly mention whether a company could be liable for the debt of its affiliate company; unless the provision is applied to affiliate company situation through interpretation, it does not clearly indicate that the bankruptcy of controlled company will be extended to that of the controlling company or individual. Particularly the use of the term “who has carried out commercial operation” is not clear whether the situation where a person or a company without carrying out the commercial operation itself just dominants or controls or influences the management of other company is covered.

Further, the proof of the three element of liability; the carrying out of commercial operation, acting not in the interest of the company and using the company as a cover not as true entity, under the rule are difficult to prove as that has to be made on transaction by transaction basis in the bankruptcy proceeding which only happens at the end of the whole operation. It is also likely that these three elements be interpreted in court as cumulative requirement because of the conjunction word "and".

That also makes the rule of limited use. Therefore this rule only makes the way whether to adopt similar liability rule in affiliate company situation, but does not fully and clearly cover the corporate group phenomenon.

3.3.2. The Current Practice

The trend in the formation of affiliate company and their method of affiliation in practice have been discussed in the first section of this chapter. As equity holding among companies is legally permissible method of affiliation some time companies cross hold shares in each other. It is discussed that the law has restricted joint holding among companies to less than ten percent and if the companies are banks however, another company could not hold more than five percent of that banks share capital whether joint or otherwise.

When it comes to practice the writer has not come across companies holding each others share beyond the ten percent legally prescribed maximum. Further, the regulatory authority, the Ministry of Trade and Industry, for non financial companies with regard to joint holding, have not so far entertained any such matter as companies joint holding beyond the legally prescribed maximum.[232] Similarly with regard to consolidated account, the practice is not known to the Ministry of Trade and Industry.[233]

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[232] Interview with Fisha Mengistu, Legal department head at Ministry of Trade and Industry, on December 20, 2009

[233] Ibid.

The practice with respect to common management as a means of affiliation has also been discussed in the first part of this chapter. An individual who holds majority share in two or more affiliated companies will be a manager of all of them. Almost all of the affiliated bank and insurance companies used to have common directors prior to the enactment of banking business proclamation.[234] There was a Civil case[235] brought to Federal First Instance Court by United Insurance Company and its directors against National Bank of Ethiopia in opposition to the directive issued by the latter prohibiting one individual to be a director in two financial companies at a time.

In this case, the argument of the defendant, the National Bank of Ethiopia was that the prohibition of common directorship by directors and avoiding the controlling influence of few individuals over the related financial companies. But the court rejected this argument on the ground that the National Bank lacked authority to specifically issue the directive. This case was affirmed by Federal High Court on civil file No. 64552, and presently pending at Federal Supreme Court. Presently none of the affiliate financial companies have common directors or officers.[236]

In another case brought to Federal High Court in a Civil file number 53096, one of the company considered in the study, Nejat International plc was sued by commercial bank of Ethiopia for the payment of 40 million birr loan, the company borrowed on Feb. 1997 G.C together with contract interest of an amount 31.5 million birr that run up to Feb. 2007 G.C and totally for an amount of 71.5 million birr. The plaintiff bank joined in the suit two other defendants, who being major shareholders of the debtor company had also stood guarantee for the company for maximum amount of 20 million birr, on the basis of guarantee contract. Finally the court holds the defendants, the company and the guarantor shareholders, liable for the suit.

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[234] Supra note 197.

[235] Federal First Instance Court Lideta Bench Civil case No. 93620. The second applicant to the first instance court Iyyasuswark Zafu was a director an chief executive office of board in Untied Bank.

[236] Supra note 172

The judgment creditor, commercial bank of Ethiopia, had also instituted a suit for the execution of the decree on a Civil file number 79431 before the same court. In this case, the judgment creditor applied to the court that Tracon Trading private limited company be ordered to pay the debt of the judgment debtor company alleging that the rights and duties of the debtor company had been transferred to Tracon Trading. So, in this case directly or indirectly the issue of inter-corporate liability (i.e. whether Tracon Trading private limited company is to be liable for the debt of its affiliate Nejat International Private Limited Company) is involved but only at execution stage, and how it will be resolved is to be seen as the case is still pending before the court.

Remember that in this first part of this chapter, Negat International and Tracon Trading Private Limited Companies are found to be tied by family relation, Tracon Trading PLC was established between Leila Mohamed Husseen and her son Seid Umar Alii who were also shareholders of Nejat International plc.[237] But at present the shareholders of Tracon Trading Private Limited Company are Seid Umar Ali and Nejat Umar Ali as is said to have transferred her share to her daughter Nejat Umar Ali by resolution of shareholder on January 2007 G.C.[238]

Other than these, the writer has not come across court case involving inter-corporate liability issue, be it on the basis of directors, officers or manager liability rule or on the basis of rules on adjudication of bankruptcy in common. Moreover most of the judges interviewed express the opinion that though there are problem with respect to company affiliation particularly in the form of private limited company, our legal system does not address them and no remedy is available for those affected by the operation of the group.[239] i.e. every company, whether in affiliate relationship or not once it is legally established, has its own separate existence and it only will be liable for its obligation and not shareholders be it an individual or its another affiliate companies.[240]

[237] Supra note 168
[238] Ibid
[239] Interview with Yosef I'emro and Berket Bushira Federal High Court Judges, Adey Nuguse, Federal First Instance Court Judge, on December 11, 2002
[240] Ibid.

Another federal Supreme Court judge interviewed by the writer also added: “after the weakening of business activity during the Derg regime, presently we see companies like MIDROC operating in affiliation and well in business. But with respect to problems that could be raised by such and similar other organizations, I remember no court case. I think currently there is no need (problem) and whether there are rules in our company law that governs these organizational situations is not well entertained in practice.”[241] Practicing lawyers also join these opinions of the judges that there exist situations where companies operating in affiliation abuses corporate veil to the prejudice of creditor while there are no clear legal rules to tackle it and that the practice is not promising.[242]

[241] Interviewee with Ato Abdulkader Mohamed, Federal supreme court judge, on January 14/2010
[242] Supra note 222,223,224

Conclusion and Recommendations

Conclusion

The study generally discusses the phenomenon of affiliation among companies as an organizational form and the legal regulation of same in the context of Ethiopia business environment. It starts with finding the meaning, nature and purpose of affiliate companies as reviewed in literature. It is stated that the phrase affiliate companies used to refer to group of companies each of which have their independent legal existence but commercially operating as a unit. The purposes for establishing affiliate companies are discussed to be transaction cost efficiency, building cooperative arrangement, reallocation through internal capital market, special tax treatment and *limiting liability*.

It is also discussed that organizations grow to take affiliate companies structure through business process either internally or externally. Internal expansion is the method of organizational growth where by an already existing large company may split into number of firms either through investment of capital in existing enterprise or the establishment of another company for the supply of input. External expansion and growth comes about by merger of two or more companies or takeover of one company by another. Such organizational growths of companies are based on share ownership, agreement between companies, common management and interlocking directors and officers. Hence capital organizations have considerable freedom, both in law and in practice, to determine the limit of their organizational boundaries or firm size and thereby choose the limit of its legal responsibility.

It is also observed that the separate legal existence of companies in affiliate relationship is not matched by economic independence of the units as one company may dominate another member company on the basis of majority ownership centralized or common management and enterprise agreement to that effect. Some of the consequences of such dominating influence are, the group company serving the interest of the controlling company; impairing the asset of member company through transfer price fixed by the controlling company, inadequate consideration paid by same and extension of credit to controlling company at a lower rate. These are found to be threatening to the interest of the units, that of its minority shareholders and creditors.

It is the protection of these interests that raised the issue of special regulation of affiliate companies. In this regard different regulatory approaches have been discussed in the paper. Countries such as Germany have plunged in to enterprise doctrine legislating limited liability away from corporate group when they operate as a single enterprise. Other jurisdictions both from civil law and common law legal systems are also finding that it is necessary to do so in at least some areas, if not yet prepared to trespass on the sacred ground of limited liability.

When it comes to Ethiopian legal system, the paper made it clear that affiliate companies are emerging as an organizational form in financial and non financial sectors of the economy. As observed in the study, except the financial companies, the forms of companies that are commonly involved in affiliation are private limited companies and their methods of affiliation includes; dominant shareholding by an individual in more than one companies, family relation, common management, common shareholders and cross shareholding between companies.

It is also stated that despite the absence of special regime for the regulation of affiliate company, there are some specific rules pertaining to affiliate company situation. These includes, rules on joint holding, rules on limitation of acquisition of shares of bank and insurance companies, rules on consolidated account; rules on liability of directors, officers and managers and rules for the adjudication of bankruptcy in common. Out of these rules the first three deal with formation, shareholding and financial reporting of affiliate companies, where as the remaining two are deemed to deal with liability matter in affiliate company relationship. However, the rules are found out to be inadequate to regulate affiliate companies proliferating in the country for the following reasons: first lack of clear definition of affiliate company as a concept. Second, the absence of clear reference (in the rules on liability mentioned above) that they apply to affiliate company situations. Thirdly, as stated so far in the study, affiliation among companies are predominantly taking place between private limited companies, where as the above discussed rules are mainly to be found in the parts of the law on share companies. These distances the affiliate company organizational structure in the country far away from the few available rules stated above. It is also found out that there is no promising practice due to the reluctance of the judicial system of the country to think behind the corporate veil of companies.

Recommendations

As concluded above there does a gap between organizational structure of emerging affiliate company and the structure of legal system currently existing for the regulation of same. So the writer recommends, the treatment of the subject of legal framework for the regulation of affiliate company in the undergoing revision of the commercial code of the country. In this light, the inclusion of some special rules that define the concept and extend in scope to both share companies and private limited companies, addressing problems inherent in affiliate company organizations from the perspective of protection of creditors, minority shareholder and proper operations of business in the country is in order

Further, an institutional mechanism to check the observance of legal requirement for the establishment and publicity of the group in affiliate relationship, and the follow up of the maintenance of such requirements while these companies operate in business has to be devised. In this regard the experience of Italy, which had devised rules that are intended to make group situation public by making their structure, link among them and the subordination status between the companies more transparent through compulsory registration in the registers of companies and indication in the director's report of the links with remaining group members, is worthy of consideration.

Finally, the legal treatment of affiliate company does not solely demand the contribution of the legislator, the judiciary could also help to resolve basic problems by adequately interpreting the rules in force. So, it is submitted, Ethiopian courts should be able to properly address the problem of abuse of benefit of incorporation and limited liability in affiliate company situation on the basis of rules discussed by familiarizing themselves with such rules without waiting for legislative reform.

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