Increasing Capital of Share Companies under Ethiopian Law

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Abstract

The biggest concern of the law during capital increase is the protection of minority shareholders. In this regard, the Code creates some safeguards. The first protection relates to placing the power of increasing capital in the hands of the extra ordinary general meeting which is subject to higher quorum and majority rules. The second protection involves pre-emptive rights of shareholders to new issue of shares in proportion to each shareholder's existing shareholding, which can only be bypassed under very stringent conditions. Where pre-emptive right is bypassed, fair valuation of new shares is provided as an alternative remedy. Other exceptional remedies include each shareholder's right to veto down capital increase resolutions, or opt-out right from the increase resolution, depending on different contexts. In terms of the authority to decide on increase, Ethiopian law recognizes the ultimate power of the shareholders meeting to determine increase of capital, including the amount and the manner of the increase. Contrary to many other laws that give wider power to the board of directors to increase capital under delegation, Ethiopian Commercial Code limits the board's power to merely implementing the decision of the general meeting. However, careful examination of the law indicates that under the delegation of the general meeting, the board can do more than merely implementing the decisions of the meeting. The law should be interpreted as allowing delegated capital increase by the board of directors in order to introduce efficiency in capital raising which, *inter alia*, may extend to the extent of exercising discretion to bypass pre-emptive rights. With such schemes, *efficiency* for the company and *fairness* towards minority shareholders should be balanced.

Keywords:

Authorized capital, capital increase, Commercial Code, pre-emptive rights, dilution

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1. Introduction

The law on increasing the capital of share companies deals with competing interests. On the one hand, there is the interest of the company to raise finance –that is necessary for its growth and competitiveness– with utmost efficiently and effectiveness. On the other hand, there is the interest of some shareholders (often minority shareholders) to keep their economic interest in the company unchanged. There can also be conflict of interest between shareholders that have the ability to supply the equity finance needed by the company quickly, and those that cannot. Increase of capital may also be favored by the board of directors for the sole reason of 'empire building', without there being genuine value for the shareholders.

In share companies, increase of capital is one of the most fundamental changes requiring a formal process of amending its memorandum of association. It changes not only the amount of the capital, but also has the potential to change the balance of economic and control relationship among the shareholders. As the legal capital (which is the nominal value of contributions made by the shareholders as stated in the memorandum of association of the company) is the basis for calculation of all the rights of shareholders[1], its increase or reduction has a direct bearing on the rights of each shareholder relative to the others.

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[1] It should be noted that among the bundle of shareholder rights the most basic ones, i.e., dividend from profit, voting and subscription for new shares, are weighted on the basis of either the paid up shares or the subscribed shares. Thus, dividends are calculated on the basis of paid up capital (Article 291/1), and votes are calculated as per the subscribed shares (Article 291/3). The right to subscription for new shares is calculated on the basis of both the paid-up shares and subscribed shares (Article 448/1). Since (under Article 445) a company cannot issue new cash shares before full payment of its capital, by the time new shares are issued the paid up capital will be on parity with the subscribed capital.

In the normal course of business, increase of capital is a natural process of growth for the company[2], and as such it is always presumed to be in the interest of the company. Corporate capital is not meant to be static; often if things go as anticipated, the company ought to grow organically from within. This is possible mainly by means of increasing the resources to be availed to the company. As capital represents the economic interests of each shareholder, increase of capital will (in the perfect scenario) result in proportional increase of each shareholder's ownership. However, not all shareholders will be willing and/or are able to subscribe for the increase whenever the increase is proposed. Where a shareholder is unable to take up an amount from the new increase proportional to their existing ownership, each shareholder's proportional economic interest and control power in the company will go down. This is generally referred to as dilution.

Hence, an act so advantageous for the company by increasing its resources may turn out to be contentious and require a delicate balancing of interests. On the one hand, the interest of the company to obtain fast and flexible financing for its operations is of high importance. A company does not have to remain indefinitely with its original capital. In the development of a business venture, the venturer has the right to increase their stock; such a right is in fact inherent to the concept of ownership.[3] But the interest of the minority shareholders against dilution of economic and control rights is equally important. Company law should thus balance these conflicting interests.

The approach adopted under the Ethiopian share company law to balance these interests is a complex one. Moreover, the manner courts have so far treated the problem require an in-depth investigation into the Commercial Code, court cases, foreign laws and practices in relation to balancing the rights of minority shareholders in the context of increase of corporate capital. This article investigates the law on capital increase in light of some court decisions.

The article has six sections: section one is the introduction; sections 2 and 3 deal with the formal and procedural requirements for increase of capital. These sections also deal with the power to increase capital, and the formality requirements for increase of capital. Section four briefly deals with the effects of increase of capital on shareholders that cannot participate in the increase. Section five addresses the protections provided to shareholders against

[2] While growth can be achieved externally by mergers and acquisitions without direct capital increase by the existing shareholders, such a growth also often can result in increasing the capital eventually.

[3] Julian Javier Graza (2000). "Rethinking Corporate Governance: The Role of Minority Shareholders-A Comparative Study" 31 *St. Mary's L.J.* 639

dilution of rights, and it presents pre-emptive rights and fair pricing of shares as protections against dilution of control and economic interests. Other alternative remedies against dilution will also be discussed in this section followed by concluding remarks.

2. The Notion of Capital Increase

As Hayes noted, *share capital* is "primarily intended as a device for financial convenience rather than as an instrumentality to carry out desired legal controls… . [T]he capital stock represents the ownership and the right to receive profits and experience losses of the corporation as an enduring and functioning business unit… ." The legal capital is "a devise which enables the corporation to accumulate capital from many sources, without requiring each contributor to enter into agreements with every other contributor. The ready divisibility and transferability of ownership interests when in stock form make it more convenient for investors, small and large to buy and sell their interests" without any effect on the underlying entity.[4]

Capital increase as a concept can be explained from different angles. From the perspective of its effect on the balance sheet of the company, capital increase can be dichotomized into real vs. nominal capital increase. On the other hand, from the method used to effect the increase, it can be increase in par value of shares vs. increase in the number of shares. Once again looking at it from the viewpoint of the beneficiaries of the increase, capital increase can be by sale of shares to existing shareholders or sale to new shareholders.

In fact, capital increase essentially comprises issuance or re-issuance of shares. In the case of increase in par value, capital increase can be characterized as re-issuance of shares than de-novo issuance. In such cases, each of the outstanding shares are changed. In contrast, increase in the number of shares entails de-novo issuance of additional shares.

2.1 Effective vs. nominal capital increase

There should be a distinction or rather a dichotomy between the process of formalizing the resources already within the coffers of the company, and the process of injecting fresh capital into the company. The former process can be referred to as nominal capital increase, and the latter as effective capital increase.[5] From the financial perspective, such a distinction is logical. An

[4] Edward R. Hayes (1954). "Authorization and Issuance of Capital Sock by the Iowa Corporation (Part II of a Study of Iowa Corporation Practices)" 39 *Iowa L. Rev.* 609

[5] Andreas Cahn & David C. Donald (2018), *Comparative Company Law: Text and Cases on the Law Governing Corporations in Germany*, the UK and the USA (Second Edition,

effective capital increase involves "the actual payment of funds to the company in exchange for the issue (or re-issue) of shares".[6] Such an increase is effective because it increases the resources available to the company. The new shares issued in return for the capital injection may be issued to the existing shareholders or to outsiders.

Nominal capital increase, on the other hand, involves the capitalization of reserves, and would increase the share capital alone without changing the assets available for the company.[7] In a way, the important point of distinction is not merely the presence or absence of payment of funds. It is rather the actual effect on the financial position of the company after the increase. Hence, an increase of capital involving the capitalization of debts (conversion of debts into equity) may be regarded as an effective increase in as far as it changes the financial position of the company.

Article 442(3) (a, b and d) of the Commercial Code makes reference to an effective capital increase, whereas sub-article (c) refers to nominal capital increase. This distinction has practical relevance in respect to validity of resolutions as will be discussed below.

2.2 Increasing par value vs. increasing number of shares

Capital can be increased either through issuance of additional shares or increase of the par value of the existing shares. Since the capital is merely the product of par value and the number of shares, increase of either multiplier results in capital increase. To this effect Article 442 (2) of the Commercial Code provides that "capital may be increased by the issue of new shares or by an increase in the par value of existing shares".[8] However, implementing capital increase by increasing the par value of share is a relatively more inflexible procedure. It has to involve all the existing shareholders implying that shareholders unable or unwilling to participate in the increase will be compelled to increase their investment or leave the company. If the existing

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Cambridge University Press) 229; *See* also, Pierre Van Ommeslaghe, *et al* (2006), "Capital and Securities of Marketable Share Companies", *Encyclopaedia of Comparative Law, Business and Private Organizations*, Vol. XIII/1, Chapter 5, p. 26

[6] Chan & Donald, *supra* note 5, at 197.

[7] Ibid.

[8] Commercial Code of Ethiopia Proclamation No. 1243/2021. Article of the 442(2) further envisages that at the time of deciding the increase of capital the general meeting shall also determine the method of increase: i.e., the general meeting should indicate the method to be used is whether by increase of par-value or by increasing the number of shares.

shareholders cannot participate, sale to non-shareholders by the company will not be possible since there are no newly issued shares.

2.3 Sale of shares to existing shareholders vs. sale to non-shareholders

There are various ways of increasing capital, and they can involve three main channels of issuing shares.[9] New shares may be issued to existing shareholders pro-rata to their respective holdings in what is usually referred to as a *rights issue*. This enables shareholders to enjoy pre-emptive rights and preserve their existing proportion of shareholding. The other way of issuing shares is public offering where shares may be issued for the *general public*. Alternatively, new shares may be issued to individual investors outside the existing shareholder base. This is often termed as *private placement*.

However, it should be clear that not all mechanisms of issuing of shares can be pigeonholed into one or the other category. Capitalization of reserves can be equated to *rights issue* when the beneficiaries of the issue are existing shareholders. If reserves are capitalized by issuing shares to employees in an employee share scheme, it would be controversial as to whether the issue can be regarded as a private placement or rights issue. Likewise, conversion of debt into equity, i.e., exchanging equity for debt cannot be categorized in any of these types though it very much resembles a variant of private placement.

Companies have reasons for choosing one method of issuing from another. Some obvious considerations in this regard include the amount of the issue, the urgency of the need for fresh capital, the existence and amount of accumulated reserves and the existence of debts or bonds convertible into shares. The amount of the issue is important in determining the method: when the issue is large enough, public issues would be appropriate because, *inter alia*, the existing shareholders may not be able to take up the entire issue, and secondly only large issues can justify the regulatory complexities of the public issuance.[10]

Such regulatory complications include shareholder approval, waiver of pre-emptive rights, disclosure and publicity requirements. On the other hand, when the issue is relatively smaller and the need for fresh capital is urgent, companies may opt for private placement. The existence of accumulated reserves may lead to the use of bonus issue. Likewise, where a company is profitable, under the normal course of business, it will use the method of *rights*

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[9] Chen Jingsham (2014). 'Discussions on the Relief of Shareholder's Interests under the Authorized Capital Systems', 2 *China Legal Sci*. 120.

[10] Paul L. Davis (2009). *Gower and Davis' Principles of Modern Company Law* (8th ed. Sweet and Maxwell) 852.

issue instead of *private placement* or *public offers*. In such cases, pre-emptive rights of existing shareholders could be preferable.

2.3.1 Sale to Existing Shareholders

Sale of shares to existing shareholders is, compared to sale to outsiders, a straight forward process. From the shareholder right perspective it is the least controversial. The usual mechanisms of sale can often be (i) *rights issue*, (ii) *bonus issue,* or (iii) *scrip issue*.

Rights issue of shares is sale of shares to existing shareholders in proportion to their respective holdings in return for new capital injection (Article 448). In many laws, the company will send a formal notice to each shareholder that gives a choice of buying the shares offered to them at discounted price which is either at par value or par value plus small premium below the prevailing market price.[11] Each shareholder is required to inform the company about the number of shares opted by them, within stipulated period which under Ethiopian law cannot be less than one month.[12] The shareholders can forfeit this right, partially or entirely, to enable the company issue the shares to the other shareholders that are willing to subscribe for more shares than their pre-emption would allow.[13] Capital increase by way of rights issue of shares is an effective increase. In principle, the right to subscribe can be sold in whole or in part.[14] Where the shares are not listed on an exchange, however, transferring the subscription right is often not practical.

Bonus issues represent shares issued to the existing shareholders of the company in proportion to their respective shareholding without any payment in return from the shareholders. Because the shares are paid from the company's reserves, "the bonus issue only raises the total number of shares issued, but it does not make any change in the entity's net worth. Nevertheless, the total number of shares issued by the companies as bonus issue increases,

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[11] In Ethiopia especially in the financial sector companies the rights issue price is often at par value.

[12] Commercial Code, *supra* note 8, Article 454.

[13] Shamsuddin "A Study of Issue of Securities to Existing Shareholders in Special Reference to Right Issues & Bonus Shares", *Journal of Humanities and Social Science* (IOSR-JHSS). vol. 22 no. 12, 2017, p. 54.

[14] Commercial Code, *supra* note 8, Article 448(2) recognizes this right: The preferred right of subscription "indicated under Article 448(1) may be disposed or assigned under the same conditions as the share itself, during the period of subscription." In listed companies, the price discovery mechanism readily facilitates the transfer of subscription rights. Indeed, a shareholder may sell a part of her entitlement in the rights issue and use the proceeds to purchase the remaining in a process called nil-paid. In such a scenario, the shareholder spends nothing from her pocket.

[while] the ratio of shares owned by the shareholder remains same."[15] Ethiopian law recognizes bonus issues under Article 442(3) of the Commercial Code stipulating that "the new shares issued may either be paid up … by capitalization of reserves or other funds at the disposal of the company." Article 442(3) also reinforces the relevance of bonus shares to the Ethiopian legal system by elaborating it further. Moreover, the Public Offer Directive of the Ethiopian Capital Market Authority defines bonus shares as "additional shares of an issuer distributed to shareholders usually in proportion to their existing holdings without the requirement for any additional payment."

Scrip issue denotes issuance of shares in place of dividends. Like bonus issues, scrip issues do not involve fresh capital injection from the shareholders –and hence entail more of a nominal increase of the capital. However, while bonus shares are paid from reserves, scrip issues are payments in lieu of dividend. While the term scrip is a UK nomenclature, its equivalent in the US legal system is Dividend Reinvestment Plan (DRIP).[16] Scrip issues or stock dividends are optional tools in the UK. Thus, "in the UK, a firm that wants to offer a dividend in the form of new shares is legally obliged to offer shareholders the choice between newly issued shares or the equivalent value in cash".[17] In the USA, DRIP scheme is said to "enable investors to reinvest their cash dividends in company shares, sometimes offered at a discount. The source of the shares can differ however, as the shares to be distributed can be new issues or treasury shares."

Ethiopian law does not explicitly recognize scrip dividend. However, the banking transactions law in the Commercial Code of 1960, Book IV (which is still in force as Art. 2(1) of the 2021 Commercial Code has only repealed Books 1, 2 and 5), recognizes scrip issues as one of the bundle of rights that a bank –entrusted with securities depository function– is required to exercise on behalf of the depositor. To this end, Article 914 of the 1960 Commercial Code –which regulates collection of yields of securities and collateral obligations– provides that a (depository) bank which deposits shares on behalf of a shareholder "shall collect free scrip issues and join them to the deposit."[18] This

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[15] Shamsuddin, *supra* note 13.

[16] See generally, Isabel Feito-Ruiz *et al*, "Elective Stock and Scrip Dividends", ECGI Working Paper Series in Finance, Working Paper N° 574/2018, September 2018, http://www.ssrn.com/link/ECGI-Fin.html

[17] Id., at 5.

[18] Commercial Code of Ethiopia (Proclamation No. 166 of 1960) Article 914(3). This provision is found in the Section dealing with *Deposit of Securities* which is regulated as a banking service which is still in force.

implies that scrip dividends are indirectly recognized in the Ethiopian legal system.

2.3.2 Sale to Non-Shareholders

Sale of shares to non-shareholders is a complicated transaction. This is because, while sale to existing shareholders is the rule, sale to outsiders is generally an exception. As shareholders have the pre-emptive right to subscribe for new issue of shares, sale to outsiders should be preceded by a decision to waive the pre-emptive right. Article 451 of the 2021 Commercial Code states the following cumbersome requirements to justify waiver:

> The extraordinary general meeting which resolves an increase of capital may also resolve that the provisions of Article 448, 449 and 450 shall not apply, in whole or in part, but after considering:
> a) a directors` report giving reasons for the increase of capital and the setting aside of the preferred right of subscription, the allotters of the new shares, the number of shares allocated to each, the issue price and the basis for determining such price; and
> b) Auditors` report certifying the correctness of the directors` report.

However, waiver of pre-emptive right is made not only in favor of outsiders. It can also be made in favor of fellow shareholders. Articles 451(2) and 451(3) contemplate sale to some of the existing shareholders at the exclusion of others. It can be understood that where shares are issued for cash consideration, the rights issue method would suffice, and discriminating among shareholders will not be justified. Therefore, the strongest justification for waiver of pre-emptive rights of shareholders in favor of others is issuance of shares in return for in-kind contributions, as the in-kind contribution (property) required by the company cannot be pro-rated among the shareholders.[19]

On the other hand, sale to outsiders can be to the *general public* (public offer) or to a selected group of buyers which is often referred to as *private placement* in the capital market parlance. When the sale is to the public, the

[19] Ibid, Article 470(1). The 1960 Commercial Code –under Article 470(1)– had limited pre-emptive rights of shareholders to cash shares- “shareholders shall have a preferred right of subscription of new cash shares, in proportion to the number of shares held.” As in-kind contributions cannot be prorated to each shareholder, the issuance of shares in return for in-kind contribution is naturally associated with waiver of pre-emptive right. *See* also Marco Ventoruzzo (2013), ‘Issuing New Shares and Pre-emptive Rights: A Comparative Analysis’ 12 Rich J. Global L & Bus. 531.

law requires a prospectus providing the required information to the public.[20] Private placement of shares however does not need a prospectus in so far as the law is concerned. Another scenario that needs waiver of pre-emptive rights is conversion of debentures/bonds into shares. However, waiver of pre-emptive rights in the case of convertible bonds/debentures[21] is made by the general meeting at the time of issuance of the security, and is limited to the size of the debentures.[22]

3. Validity Requirements for Increasing Capital

3.1 The authority to increase capital

In Civil Law systems, any increase of capital results in altering the founding charter of the company, and therefore lies within the mandate of the general meeting of shareholders. On the contrary, "in the Anglo[23]-American systems, the company's charter fixes an upper limit to the authorized or nominal capital within which the board of directors has considerable freedom to issue shares according to the company's needs".[24] Hence, while approval by shareholders meeting is always a necessity for increase of capital in one way or another in the Civil Law traditions, the same is required in common law systems only for the purpose of raising the authorization limit fixed in the Charter.

A lot can be said about the above divergence between the two systems. One crucial factor is the function of capital in each system. In Civil Law systems, the main function of capital is the protection of creditors, and as such it is fixed in advance and can be altered under severely regulated conditions. In the American system on the other hand, capital does not have as its main objective the protection of creditors, and hence can be increased relatively easily.[25] The authorized capital in many state laws in the US may lead creditors into believing that it represents the assets of the company, while it does not.

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[20] Commercial Code, *supra* note 8, Article 447 requires public prospectus and provides what should be included in the prospectus.

[21] Debentures are bonds issued by share companies. The Commercial Code regulates the issuance and administration of debentures from Article 407-424- Commercial Code, Supra note 8.

[22] Commercial Code, *supra* note 8, Article 452

[23] The English have abandoned the authorized capital since the 2006 Companies Act. See Paul L. Davis, *supra* note 10, p. 260.

[24] Ommeslaghe *supra* note 5, pp. 5-36.

[25] Ibid.

3.1.1 Increase of capital by the general meeting of shareholders

In Civil Law legal systems, increase of capital must be approved by the general meeting of shareholders. To this effect, there is harmonization of laws in the European Union by virtue of the Second Company Law Directive.[26] This is based on the premise that as increase of capital has profound effect on shareholders, the power to decide is given to shareholders general meeting.

Shareholders' meetings can have different alternatives of using this mandate to increase capital in the most flexible manner without hampering the financing flexibility and endangering shareholder rights. The most regular form of exercise of power by the shareholders' meeting to increase capital is where it determines all the terms of the increase such as the amount, timing, the price, and the recipients of the issue.[27] In such cases there is little discretion, if any, for the board of directors except implementing the instructions of the shareholders' meeting. Often it is the management that implements these resolutions. Company laws provide strict procedures as to convocation of meetings, rules as to quorum and majority votes, and minutes of resolutions for the validity of such an increase.

Shareholders' meeting may also exercise its power to increase capital by delegating its power to the board of directors. Such a resolution is in a way an advance vote by the shareholders for increase of capital. Thus, the actual increase of capital is often implemented at a certain future date by the broad of directors as and when the company needs fresh capital.[28] Most Civil Law countries have this procedure of an advance vote on increasing capital by delegating or giving authorization to the board to increase capital.[29]

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[26] The Second Company Law was enacted in 1977, but has since been updated at least twice in 2006, and 2009.

[27] Chan & Donald, *supra* note 5, p. 198.

[28] In most Civil Law Countries including France, Germany, Italy, Belgium, and Ethiopia the maximum period is five years.

[29] In the EU, for instance DIRECTIVE 2017/1132 of 14 June 2017 relating to certain aspects of company law, Art. 68.2, provides that

> "the statutes or instrument of incorporation or the general meeting, the decision of which is to be published in accordance with the rules referred to in paragraph 1, may authorize an increase in the subscribed capital up to a maximum amount which they shall fix with due regard for any maximum amount provided for by law. Where appropriate, the increase in the subscribed capital shall be decided on within the limits of the amount fixed by the company body empowered to do so. The power of such body in this respect shall be for a maximum period of five years and may be renewed one or more times by the general meeting, each time for a period not exceeding five years."

This is a clear reference to authorized capital procedure.

The board enjoys broad discretion as to when to increase the capital. German law has an additional form of delegation to the board to increase capital on certain conditions –conditional increase by the board of directors. In these cases the board will be authorized to increase capital only for specific purposes listed in the resolution such as to cover convertible bonds to be exchanged for shares.[30] In all these cases, the shareholders control the increase of capital by voting either in advance or at the time of the increase.

3.1.2 Increase of capital by the board of directors

In many state corporate laws in the US, the authorized system of capital prevails. Under these systems, the company's statutes fix the upper limit of the (authorized) capital without the need for amending the company's charter. It is the power of the board of directors to increase the capital within the limit of the authorized capital. The power to increase the authorization limit is within the power of the shareholder's meeting, while the board has the power to increase capital within the authorized limit. Hence, the board of directors "cannot issue shares beyond the authorized capital, and any purported issue of shares beyond it, is void".[31]

The origin of the authorized capital dates back to the period where the formation of corporations was sanctioned by state legislative acts. These legislative enactments authorized the formation of the company, as well as the amount of capital –hence, authorized capital. Reflecting on the legislative intention behind the authorization, Adlolf Berle stated that "our great grandfathers had not the slightest intention of allowing these fictitious collective persons to roam the world, possessing indefinite wealth, or to dominate the commercial industrial scene".[32]

Though the requirement of legislative assent for formation of companies was abandoned long ago, the authorized capital has survived to this day especially in the US and other common law countries. This is so because, "as the general acts of incorporation began to replace the creation of corporations by special legislative acts, the new corporation statutes like the special acts of incorporation required that a maximum number of shares and a specified par value per share be stated in each corporation's articles of incorporation."[33]

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[30] Andreas Chan and David C. Donald, *supra* note 5, p. 231.

[31] P. Blais (1961), "'Shareholders' Protection from Share Watering Caused by the Additional Issue of Shares: Pre-emptive Rights" 19 *Fac. L. Rev*. 47.

[32] Adolf A. Berle, Jr. (1950), "Historical Inheritance of American Corporations, 3 Social Meaning of Legal Concepts" 189, cited in James J. Jr. Hanks (1995), "Removing the Limits of the Authorized Stock"*73 Wash. U.L.Q*. 486.

[33] Hanks, Ibid.

However, in a clear break from its historical objectives, the authorized capital system facilitates capital formation much more easily than the more conservative approach followed by the Civilian systems. The authorized capital system tries to strike the right balance between the financing needs of the company and shareholder rights. It gives shareholders "some control over the financial structure of the corporation. Sales of shares that might dilute shareholders' ownership of the corporation above the threshold set by the authorized shares must be voted by the shareholders as an amendment to the articles of incorporation;" but an issue of shares within the authorized limit is at the board's discretion.[34]

Especially, in the USA the absence of minimum capital[35] requirement for forming companies greatly simplifies company formation because a company can be established with a paid capital as low as 1 USD. In contrast, "a minimum capital is required in public companies by Article 45 of Directive (EU) 2017/1132 and is therefore found in the legislations of all EU member states".[36] Under the Directive (EU) 2017/1132, the minimum capital of a public company cannot be less than 25,000 Euros. UK company law is in contrast cautious in its treatment of minimum capital requirement as compared to the US law. Therefore, minimum capital is required only for public companies in the UK.[37]

One may inquire what purpose capital serves in such instances both in the UK and USA. Although minimum capital in the Civil Law systems is mainly considered as a protection for creditors, and a price to be paid for limited liability, its practical value in achieving these objectives is said to be ineffective. However big the amount of the minimum capital is, it is going to be spent for the company's operations as soon as the company commences business. So, the idea that the minimum capital serves as security for creditors against insolvency is not realistic.

Secondly, the minimum capital is merely symbolic in many cases as it is untenable to fix the amount of initial capital that can prevent each new business from insolvency. Hence, US law has abandoned minimum capital requirement, and has instead opted for the ease and flexibility that nominal capital (coupled with the authorized capital) provides for company formation and expansion. UK law takes somewhat a mixed approach. Instead of

[34] Ventoruzzo, *supra* note 19.
[35] Cahn & Donald, *supra* note 5, 204.
[36] Id, at 191.
[37] Paul L. Davis & Sarah Worthington, (2012). *Gower and Davis' Principles of Modern Company Law* (9th ed. Sweet and Maxwell) 273.

minimum capital, UK and USA corporate laws focus on disclosure and ex-post liabilities for corporate managers as a means of creditor protection.[38]

Indeed, the need for easy and flexible financing is of paramount importance. After formation, a company's needs for further financing is a normal expectation of growth and expansion. Hence, the board will have the freedom to raise the necessary capital without the need for shareholders' vote and amendment of the articles of incorporation. Such is the design of the system of authorized capital. However, in practice the authorized capital is criticized for it leads companies to provide for an amount of authorized capital significantly larger than the amount of the issued capital, so much so that the initial design of protecting shareholders from dilution is defeated.[39]

Where the authorized capital is lower, it will be depleted sooner and directors would have to go back to the shareholders and undertake the process of amending the articles of incorporation.[40] Where the authorized limit is too high, it leads to dilution of existing shareholders. Japanese Company law tries to balance the shareholder vs. board power by limiting the authorization to a maximum of four times the issued capital.[41]

In Civil Law systems, even though authorized capital is not recognized at the time of formation, it is used during capital increase. German law appears to balance the above concerns. It allows two types of advance authorizations for directors during capital increase. First, shareholders may delegate the board "to increase capital and issue shares according to their own discretion, excluding shareholders' preemption right pursuant to the delegation of authority during future period, which can have a maximum of five years".[42] This is the standard practice for authorized capital increase in the Civilian legal tradition. As discussed above, the Ethiopian Commercial Code pursues this approach under Article 443, even though whether the Board can exercise discretion to bypass the preemption rights of existing shareholders is not so clear.

The second type of advance authorization of capital increase is somewhat unique to German law whereby "shareholders may create a conditional increase of capital that may be used only for specific purposes listed in the company law such as to cover convertible bonds being exchanged for shares

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[38] Id, at 271.
[39] Cahn & Donald, *supra* note 5, 204.
[40] Hayes, *supra* note 4, p. 492-493.
[41] Reinier Kraakman *et al* (2009). *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd Ed, Oxford University Press) 188.
[42] Cahn & Donald, *supra* note 5, 231.

… to pay for mergers and to fund stock option plans".[43] Even though Ethiopian law does not expressly provide conditional authorization like the German law, or even if it does not explicitly state whether the board under the authorization can sidestep the preemption rights of existing shareholders, such details can be provided in the resolution of the general meeting.

3.2 Procedural requirements for increase of capital

As the act of increasing capital introduces fundamental changes into the company, it is subject to some strict procedural requirements. From comparative point of view, most Civil Law or Continental legal systems require amendment of the corporate charter for the consummation of capital increase.[44] In the Common Law, however, shareholder meeting resolution and amendment of charters is needed only when the capital increase exceeds the authorized limit.

Under Ethiopian law, increase of capital involves at least four separate requirements. These are: (i) full payment of the hitherto subscribed capital, (ii) general meeting resolutions, (iii) authentication and registration of the amendment resolution, and (iv) depositing the resolution in the Commercial Register. The first is a substantive requirement and applies in the case of increase to be paid by cash or conversion of debentures, while others are merely procedural and apply in all capital increase situations. That is, the procedural requirements apply invariably for all capital increasing exercises, i.e., whether the increase is real or nominal, whether it is implemented by increasing the par value or the number of shares, or whether the new shares are issued to new shareholders or existing ones.

3.2 1 Full payment of the subscribed capital

As a substantive requirement, Article 445 of the Commercial Code states that "where a company whose capital is not fully paid increases its capital by new issue of shares to be paid in cash or convertible debentures, such issue shall be null and void." The law is not clear enough about the rationale of this requirement. But one may assume that it is inspired by the policy of compelling the old shareholders to first fulfill their initial subscription commitments before calling upon additional equity from members or the public.[45] The provision seems to allow relaxation of the requirement of full payment of subscribed capital in case of capitalization of reserves, and shares paid for in-kind.

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[43] Id. at 231-232.
[44] Cahn & Donald, *supra* note 5, p. 230.
[45] Ommeslaghe et al, *supra* note 5, p. 26.

Increase of capital by capitalization of reserves –whereby new shares are allotted to the shareholders with the corresponding payment being offset by the reserves– is not prohibited. It would be a futile exercise, if companies do that without first offsetting the unpaid shares. Any issue of shares from reserves should first settle the unpaid portion of the shares from the earlier issue before new shares are issued.

In respect to in-kind contributions, companies may be allowed to issue new shares before full payment of the subscribed capital due to the peculiar nature of in-kind contributions. When a company wants to obtain property such as land or building in a particular location or the assets of another company by way of takeover or an intellectual property in return for shares in the company, putting the full payment of prior subscription as a condition will not serve much purpose. These types of assets may not be available for cash, and in effect, payment of the outstanding subscription from the existing shareholders cannot finance the acquisition.[46]

3.2.2 General meeting resolutions

Like most Civil Law systems, Ethiopian law empowers the extraordinary general meeting to increase the capital. The cumulative reading of Article 442 and Articles 399 to 403 of the Commercial Code reveals that only the extraordinary general meeting can increase the capital of the company. The quorum required to constitute a valid extraordinary general meeting is a third of the share capital for the first meeting, and a quarter for the second meeting. As to voting, two-thirds majority of the share capital present at the meeting suffices for validity of resolutions.

The Commercial Code provisions on quorum and majority with respect to capital increase are somewhat slippery. First, there is an exception where the law requires unanimity for increase of capital under Article 402(3). That is when an effective capital increase is to be implemented by increasing the par value of the existing shares than by issuing new shares. In this exceptional scenario the law requires unanimous vote of all the shareholders. Understandably, the logic behind this provision is that no shareholder should be expelled from the company due to the inability or unwillingness to increase their investment, because if the par value increases, the dissenting shareholder cannot remain with the old par value shares.[47] The unanimity requirement in this context seems widespread in the Civil Law legal system.[48]

[46] Ibid.

[47] Fekadu Petros (2022). *Ethiopian Company Law* (3rd Edition, Far East Printing) 360

[48] Ommeslaghe et al, *supra* note 5, p. 27.

However, there were tendencies to interpret this provision as though it applies in all cases of capital increase situations inferring that a single shareholder regardless of the amount of their shareholding can always veto a resolution to increase capital. In *Mesfin Shiferaw v. Zemen Bank*[49] the Court not only made an erroneous conclusion by failing to distinguish the principle and the exception, it also misinterpreted the provision literally to create a veto power in favor of every shareholder in every capital increase situation. Such interpretation is not tenable.

However, the circumstances where each shareholder has a veto power over capital increase (technically a unanimous vote rule) is different from the opt-out rule which is stipulated under Article 402(3), first sentence. Article 402(3), first sentence, does not empower each shareholder to veto capital increase. It only gives the right to opt out from new issue of shares to be paid in cash. The provision reads: *"an extraordinary general meeting may not pass a resolution compelling a shareholder to increase his investment in the company."* However, this should be distinguished from the text immediately following it which provides that "except in the case of increase of the capital from reserve funds or profits which may be distributed, the consent of all shareholders shall be required to increase the capital of the company by increasing the par value of the existing shares."

This part of the provision requiring unanimous vote is more clearly set out in Article 442(4) which provides: "[a]n increase of capital by increasing the par value of existing shares may only be effected under Sub-Article (3) of Article 402 of this Code unless such increase is paid up by capitalization of reserve or profits which may be distributed to shareholders." One can thus infer that three types of rules on quorum and majority apply in various situations of capital increase.

A. payment for the shares is required to come from each shareholder where effective capital increase is implemented by increasing the *par value* of shares;
B. payment for the shares is required to come from each shareholder where effective capital increase is implemented by increasing the *number* of shares; and
C. payment for the shares comes from the company's coffers where *nominal capital increase* is implemented by increasing the par value of existing shares or by increasing the number of shares.

[49] *Mesfin Shiferaw & Meseret Degefaw vs. Zemen Bank S.C.* Federal First Instance Court, File No. 190351, July 2, 2012.

Scenario A requires unanimous vote as each shareholder will have a veto power. In scenario B, each shareholder has an opt-out right. This means when the extraordinary general meeting resolves to increase the capital, each shareholder has the right not to participate in the increase. However, scenario C is even grimmer from the dissenting shareholder's perspective. A dissenting shareholder under this scenario can neither veto the decision to increase the capital, nor opt-out from the majority decision to pay for the new shares. In other words, shareholders can opt-out of *rights issues*. On the other hand, they can have neither veto nor opt-out right in case of *bonus issue* and *scrip issues*.

Another issue that needs to be examined in connection with this is whether the board can decide to choose from the methods in A, B and C above. In this regard, Article 443(1) is not ambiguous. Only the extraordinary general meeting can determine the exact amount by which the capital is to be increased,[50] and the method of increase (i.e., by increasing the number of shares or increasing the par value of shares) while it can delegate the board to determine other terms and conditions of the increase. The board can thus determine whether the increase should be real or nominal, the timing of the increase, etc. The board can also implement the increase within the authorized limit either in one go, or at different times as far as it does not delay the increase for more than a period of the five years provided under Article 444.

3.2.3 Authentication and registration requirements

Since increase of capital alters the terms of the memorandum of association, Proclamation No. 922/2015 requires authentication and registration by the Documents Authentication and Registration Service (DARS). Although the Commercial Code of 1960 did not envisage this requirement, the new Commercial Code recognizes the prerequisite of registration.[51]

Registration by DARS and registration in the Commercial involve distinct processes, and they do not substitute one another. The requirement of authentication and registration by DARS is a validity requirement; and a document required to be authenticated and registered by DARS will have no

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[50] This means the number of new shares to be issued shall be determined by the extraordinary general meeting. Logically, it should also be the power of the extraordinary general meeting to determine the class of shares to be issued. Hence, the board cannot issue preference shares in the course of implementing the power bestowed on it under Article 443 of the Commercial Code. In as far as issuance of new class of shares (such as preference shares) can significantly water down the rights of ordinary shareholders, it cannot be inferred from general delegation of implementation power contemplated in the provision.

[51] Commercial Code, *supra* note 8, Articles 265(3) & 377(2)

legal effect unless the procedure is complied with. The lack of entry of documents in the Commercial Register does not have such a severe consequence on the validity of the documents. Moreover, authentication and registration requirement is an exceptional requirement applicable to memorandum of association, articles of association, and the resolutions amending them. The requirement of entry in the Commercial Register applies to a broader class of documents including amendments to the articles and memorandum of association, all minutes of meetings, audit reports, attendance of meetings, annual reports and balance sheets.

3.2.4 Entry into the Commercial Register

The main purpose of entry in the commercial Register is disclosure to third parties. Disclosure is indeed one of the main obligations of companies. It is said that the advantage of limited liability is given in return for disclosure of information to the public. Hence, third parties are entitled to know the situation of the company periodically, as well as following important events such as changes as to the capital, membership and business objectives.

The Commercial Code has various disclosure provisions such as Articles 265, 312, 314, and 441. Likewise, the Commercial Registration and Business Licensing Proclamation requires that any change to the initial entry into the register shall be entered in the register.[52] Hence, as resolutions increasing the capital alter the initial entry in the Commercial Register, they should be entered in the register.

It is to be noted that the entry of minutes of resolutions in the Commercial Register is not a validity requirement, and thus lack of registration would not render the minutes void. Its consequence may be non-enforcement against third parties and possible administrative sanction for the failure to register on time. In any case, as between the shareholders and the company as well as its board of directors, the minutes will be binding even if they are not registered.[53]

4. The Effects of Increase of Capital on Shareholders

Change in the capital by way of increase often has a positive effect on the company. However, the effect of capital increase on shareholders depends on various contexts. For the shareholder, ownership of share represents three types of rights: (a) the right to vote and thus to participate in controlling the company's affairs; (b) the right to a portion of the company's profits in the

[52] Commercial Registration and Licensing Proclamation No. 980/2016, Article 10(1).

[53] Article 391 of the Commercial Code tends to protect resolutions from being challenged for invalidity even when the resolution is not registered. From the wording of Article 391 one can infer the policy of presuming resolutions as valid even if not registered.

form of dividends; and (c) the right to participate in the distribution of the company's assets upon dissolution and winding up.[54] There are also other membership rights which are not weighted by share ownership.[55]

Where all the shareholders increase their shares proportionally, the resultant increase of capital does neither increase nor reduce the relative ownership of each shareholder against the other. However, where one or more shareholders fail to increase their shares proportionally to their existing shareholding, there follows a dilution of the above rights. Dilution of the right to vote and thus to participate in controlling the company's affairs can be referred to as dilution of control rights; and dilution of the rights to corporate profits and the right to distribution of the company's assets upon dissolution is generally dilution of economic rights.

4.1 Dilution of control

Dilution of control rights results when the relative voting power of a shareholder weakens due to non-participation in new share issuance. Depending on the nature of the corporate enterprise, the dilution may be real or theoretical. In closely held companies (companies with smaller number of members) the dilution of control may be more impactful on the shareholder where the shareholder fails to take up their proportional shares in the increase. In such companies dilution may result in shifting control from one or a group of shareholders to another.

If, for example, a company has five shareholders each owning 20% of the share capital, any three of the shareholders will constitute a majority. If the company increases its capital by 100%, and three of the shareholders fail to buy newly issued shares, the entire new issue will go to the two remaining shareholders. The result would be that the three shareholders that together possessed 60% of the votes will have 30%; while the other two who had only 40% of the votes before the increase will possess 70% of the votes. This will automatically result in shifting control in favor of the two shareholders. Such a group will have ultimate control over key matters: it can control dividends, future issues of shares, and other allocations of company resources.

On the other hand, in large companies with dispersed ownership of shares shareholder inactivity and disinterest in management make the voting right of little value.[56] Even if the shareholder is active in terms of exercising their

[54] Florentino P. Feliciano (1953). "On the Shareholders' Right of Preemption: Law and Practice". 28 *Phil. L.J* 446.

[55] The right to information is not weighed by ownership state in the company.

[56] Feliciano, *supra* note 54, p. 456.

voting rights, such an exercise rarely translates itself into an exercise of control. It may be asserted that in such companies, a shareholder's interest tends to be mainly economic. Yet, there would be the dilution of control. Since voting is the only way a shareholder could maintain their relative control in the company –however small the percentage of shareholding– any failure to participate in a capital increase would only diminish even the hitherto existing small percentage of control.

4.2 Dilution of economic interest

While dilution of control is related to the person to whom the new shares are assigned, economic dilution concerns itself with the price at which new shares are issued.[57] This means that the shares may be issued to a stranger, and there may be no economic dilution if the shares are sold at a fair market price. "Where the additional shares are to be sold at a price which fairly reflects the existing worth of the company and its potential for growth, the shareholder has no legitimate right to demand that the shares ought to be sold to him to preserve his financial position."[58] However, the same cannot be said where the shareholder was concerned with voting rights. Regardless of the price at which the shares have been sold a shareholder will suffer dilution of control if the shareholder's portion of the new shares are sold to another person –who may be a non-member or a shareholder.

The nature of economic dilution can be illustrated as follows. As in the previous example, suppose that a company has five shareholders with 100,000 Birr capital with each shareholder owning 20 shares. This means that the par value of the shares is 1000 Birr. Suppose also that the company has accumulated reserves of 50,000 Birr in excess of its capital. Thus, if the company issues 100 new shares to a third party, the price of each share should be 150,000/100=1500 Birr. Issuance of the shares at this price will not dilute the economic interests of the existing shareholders. If the shareholders opted for distribution of the surplus 50,000 Birr as dividend, each will receive 50,000/100 x20= 10,000 Birr.

If on the other hand, they dissolved the company and distribution took place, the share of each shareholder will be 150,000/100 x20=30,000 Birr. If the two options i.e., distribution as dividend or distribution after dissolution takes place just after the sale of the new 100 shares at the fair market price of 1,500 Birr, the existing shareholders will receive the same amounts. If the

[57] Id., at 452.

[58] R. J. Hay (1984). "The Shareholder's Pre-emptive Right: Prevention of Director Abuse in New Share Issuance", 9 *Can. Bus L.J.* 2 23.

reserves after the increase 100,000 Birr (50,000 existing reserves plus 50,000 from new premium) is distributed as dividend, this will mean 100,000/200x20=10,000 Birr. Likewise, if the company is dissolved just after the increase, the proceeds of the old shareholders will not change. They will receive 300,000/200 x20=30,000 Birr.

If the new shares were issued for a price lower than their fair market price, that will entail economic dilution proportionate to the shortfall in price. In contrast, the voting rights will always be diluted irrespective of the price at which the new shares are issued. Here the question is not at what price, but to whom the new shares are issued.

Finally it should be noted that both dilution of control and dilution of economic interest do not have effect on the company. As for voting, the company does not exercise voting rights. On the other hand, the issuance by the company of new shares below their market value does not lead to any economic harm on the company as it has lost nothing.[59] If anything, it would be in a better financial position than before due to the increased capital. In such cases

> the only sense in which the company has lost anything is that it may have forgone a better price for its shares. Yet the company cannot be said to have lost an asset, for the supply of shares is theoretically unlimited; and as long as the company raises the capital, it is not in any worse a position by having sold its shares at a price that is below the book value of its existing shares.[60]

In light of the issues highlighted above, increase of capital may have the negative effect on shareholders; i.e., dilution of control and economic participation. Thus, there is the need for legal protection of shareholders against these adverse consequences of capital increase.

5. Protections of Shareholders against Dilution of Rights

There are two major protections against dilution of control and economic rights. These are *pre-emptive rights* and *fair pricing* of the new shares. In addition to these, there can also be further protection provided in law or in corporate charters such as *minimum price provisions*, and *shareholder approval rights*.

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[59] Blais, *supra* note 31.

[60] Id., FN 4, in Blais.

5.1 Pre-emptive rights

The notion of pre-emptive right refers to each shareholder's entitlement to subscribe for a new issuance of shares in proportion to their holdings of outstanding shares before the new shares are offered to others. The rule "recognizes in shareholders an affirmative privilege of a prior opportunity to subscribe to new shares created by the corporation, and imposes on the latter the correlative duty to refrain from offering its new shares to the general public until its constituents" claim of priority has been satisfied.[61]

The primary function of pre-emptive rights is prevention of dilution of control, i.e., maintaining the controlling status quo regarding "shareholder's right to vote and thus indirectly to control and manage corporate affairs".[62] In this sense, pre-emptive rights aim to preserve the hypothetical equilibrium established between the shareholders at the time of initial capitalization of the enterprise.[63] It can be said that shareholders have reasonable expectations about the continuity of the initial proportion of share ownership –and hence relative control. Moreover, pre-emptive right is the only way voting shareholders can maintain their relative control when additional shares are issued by the company.

In contrast, the effectiveness of pre-emptive rights in preventing dilution of economic rights is not as convincing. Though pre-emptive rights can contribute towards protecting minority shareholders from expropriation effected due to issue of shares to others below market value, the more effective protection would be issuance of the new shares at their fair value. It may be in the collective interests of all members for new shares to be issued to outsiders in so far as this option would yield the best price for the company, even though that would mean exclusion of pre-emptive rights.

Nevertheless, pre-emptive right is one of the major rights that shares confer upon their holders under Articles 291 and 446 of the Commercial Code. However, it is not in the category of rights inherent in membership under Article 363 of the Code, i.e., rights which the general meeting cannot alter or take away. It is this peculiar feature of the right –that it can be denied by the general meeting– which requires a thorough investigation with regard to the issue as to when the right can be waived. The other issue relates to the scope of the right to pre-emption, i.e., whether the right applies to ordinary shareholders with respect to issuance of preference shares. The same question

[61] Feliciano, *supra* note 54, p. 443.
[62] Hay, *supra* note 58, p. 3.
[63] Id., at 4.

can be asked in relation to rights of preference shareholders to pre-emption in respect to new issue of ordinary or preferred shares.

Scope of pre-emptive rights

The scope of applicability of pre-emptive rights to shares is a rather unsettled matter. As Hay noted:

> the pre-emptive right is … granted to the holders of common shares since those shares have both voting rights and unlimited financial participation and thus are the most vulnerable to dilution. Holders of non-voting shares with limited financial participation have occasionally been deprived of a pre-emptive right in the issue of new stock where no dilution of those shareholders' financial or control position would result from the issue of new shares.'[64]

Indeed, as explained earlier, pre-emptive rights are most effective for preventing dilution of control. Since, preference shares are often deprived of voting rights, the applicability of pre-emptive rights for preferred shareholders would seem unnecessary in this particular context.

It would however be hard to pin down a simple generalized rule as to the applicability or otherwise of pre-emptive rights for preferred shareholders. In one US case it was decided that "voting but non-participating,[65] preferred shareholders have no pre-emptive rights to a proposed issue of non-participating, non-voting preferred stock".[66] Likewise,

> where the existing preferred shares are non-participating and non-voting, their holders will have no pre-emptive rights to any additional shares of whatever class. In the former case, the additional preferred shares being non-participating and non-voting cannot affect any interest of existing shareholders. In the latter case, the existing preferred shares being non-participating and non-voting do not have any rights that can be affected by any additional shares; they are roughly in the position of ordinary bondholders.[67]

The question whether or not preferred shareholders have pre-emptive rights depends therefore on the nature of the preference shares, and the nature of the

[64] Ibid.

[65] The expression participating relates to preferred shareholders' right to be paid specified dividend in precedence to other shareholders, and distribution of surplus assets up on winding up. A non-participating preferred shareholder receives upon liquidation an amount equal to the initial investment plus unpaid dividends.

[66] Feliciano, *supra* note 54, p. 461.

[67] Ibid.

new shares to be issued. As a matter of principle, preference shareholders will have more than a pre-emptive right –or an exclusive right to purchase new ordinary shares– if their preference relates to subscription for new shares under Article 279 of the Commercial Code.

Similarly, preferred shares will have preference over new preferred shares of the same class, since without pre-emption these shares will dilute their economic rights. Conversely, preferred shares would not have pre-emption over ordinary shares unless the preference pertains to new subscription, and involves participation rights in the outstanding dividend after the preferred rate. Obviously, where the preference shares are participating, new common shares will eventually dilute the economic rights of the preference shareholders.

As for the pre-emptive rights of ordinary shareholders on new preference shares, it is difficult to identify a definitive rule. Apparently, in every situation where new preferred shares are issued, existing ordinary shareholders appear to suffer some loss as preference shareholders will take precedence on distributions or on new issues of shares. For instance, issuance of new preferred shares providing preference in relation to subscription for ordinary shares can transfer control from ordinary shareholders to preferred shareholders.

It would be helpful to consider the type of potential dilution the new shares will cause. If the dilution relates to cases such as issuance of new preferred shares in respect of subscription for future shares, the applicability of pre-emptive rights would be logical. On the other hand, if the potential effect of the new preference shares is on dividends or repayment of contributions upon winding up, pre-emptive rights may be excluded in favor of the more efficient remedy of fair valuation of the shares.

5.2 Fair pricing of the new shares

The other major protection against dilution is fair pricing of the new shares. Unlike pre-emptive right which is addressed to the control rights, the right to fair pricing of the new shares serves as a protection against economic dilution. However, where new shares are sold to outsiders or to selected members for a price lower than their fair value (share watering) those shareholders who are denied their pre-emptive rights suffer economic dilution. Before we deal with the issue of what is a fair price, it is important to note that the whole point of fair pricing arises only in cases where the shares are sold to outsiders or to selected group of the shareholders disregarding the pre-emptive rights.

Where the new shares are sold in a *rights issue,* no damage to the shareholders can arise. In such cases, the premium which would have resulted had the shares been sold to outsiders belongs to the shareholders anyway. “If

they are required to pay a premium for the new stock, the premium representing the surplus, they are in effect being charged for something to which they already had a legal right".[68] The premium is supposed to play a leveling role between the old shareholders who took risks in financing a fledgling business, and new shareholders who purchase shares in a business with a proven profitability. The same justification would apply in favor of imposing premium on the issue when the entire new shares are assigned to some of the existing shareholders with the exclusion of others.

Therefore, where new shares are issued excluding pre-emptive rights, the value of the new shares should be determined fairly. But what is a fair price? There are alternative approaches to fair pricing. A distinction is often made between par value, market value and book value. The *par value* is the nominal value of the shares; and it would be inapplicable where the market value and/or the book values are above par. The other approach is *market value,* i.e., the price determined by the market, which often means the stock market valuation of the shares.[69] Thus, in countries where there is no stock market, the determination of market price can be quite a challenge in practice. Under such contexts, the only plausible option will be to rely on the *book value* of the shares.

The book value of a share can be easily gathered from audit reports of the company. It refers to

> the amount which would be distributed to the holder thereof upon a theoretical winding up (at the time of valuation). Where the company has only one class of shares outstanding, the book value of such shares is the equity of the company per share, or the difference between the assets and liabilities of the company divided by the number of issued shares.[70]

Valuation of shares is often a delicate matter in most jurisdictions even with an advanced accounting and financial reporting system. In countries which lack strong financial institutions such as audit firms, stock markets, and rating agencies, the problem of share valuation is exacerbated. It should be noted that one of the conditions for the exclusion of pre-emptive rights under Article 451 of the Commercial Code is directors' report and auditors' confirmation of 'the price of the shares and the method of determination of the price.' This

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[68] Feliciano, *supra* note 54, p. 468.

[69] Kristoffel Grechenig (2007). "Discriminating Shareholders through the Exclusion of Pre-emptive Rights" 4 *ECFR* 578

[70] Blais, *supra* note 31, 46.

requirement indicates the company's obligation of fair pricing of the shares where pre-emptive rights are excluded.

However, the consequence of pricing the shares below their fair value is not set out so clearly. Depending on the legal system, different jurisdictions clearly stipulate consequences for unfair pricing to the detriment of existing shareholders. In many Civil Law countries, "the failure to price shares at a premium when there is no preferential subscription right will invalidate the issuance".[71] On the other hand, in most common law systems, "the directors are held liable … since they have the duty to issue the new shares at the best possible price, and in any case to avoid any fraud of the minority's right".[72] Even if Article 451 of the Commercial Code does not provide such sanction for failure to observe the requirement of price information and audit confirmation, directors can be held liable under the law. However, cases against directors for breach of duties are generally rare, and mispricing of new shares sold to outsiders is unheard of.

5.3 Non-applicability of pre-emptive rights

In company laws, pre-emptive rights are not unlimited. Pre-emptive rights may be excluded for a variety of reasons all having to do with the interest of the company. But the nature and purpose of exclusion of the right often varies with the legal systems. For instance, in various states in the US, pre-emptive rights do not apply for issue of shares within the authorized capital limit, implying that shareholders are aware, and already have accepted the risk of dilution up to the authorized amount.[73] But the more prevalent situation where pre-emptive rights are set aside pertains to the interest of the company. Often complying with pre-emptive rights of shareholders is time taking, and may hamper urgent financing needs of the company.

It is with the view to obtaining flexible financing that companies may exclude pre-emptive rights of shareholders. Most company laws permit this in the form of authorized capital whereby the board of directors is authorized to increase the capital in any manner it considers appropriate including the exclusion of pre-emptive rights of shareholders. In this respect, Article 451 of the Commercial Code permits the non-application of pre-emptive rights subject to the condition that the general meeting of shareholders resolves so after evaluating directors' proposal for an increase of capital, the justifications for exclusion of pre-emptive rights, the assignees of the new shares, the

[71] Ommeslaghe, et al, *supra* note 5, p. 96.
[72] Ibid.
[73] Feliciano, *supra* note 54, p. 481.

number of shares allocated to each, the price of the shares and the method of determination of the price. The general meeting is required to consider the report of the auditors in verifying the directors' report.

The exclusion of pre-emptive right seems to be so sensitive that the Code stipulates exceptionally higher quorum and majority votes than what is required for extra-ordinary general meetings. To this end, Article 451(3) of the Commercial Code states that "the quorum and majority required for such decision shall be calculated on the whole of the shares making up the share capital but to the exclusion of the shares held or represented by such allottees.'

The practical circumstances in which the exclusion of pre-emptive rights under Article 451 shall apply may vary. One typical scenario will be sale of shares to employees in what is often referred to as employee share schemes. Another setting can be a company's decision to set off its debts in exchange for new shares for which Article 451 can be relevant. Moreover, this exception can apply in case of mergers. In a merger, the assets of the acquired company are transferred to the acquiring company which issues new shares that will be given to the shareholders of the acquired company in accordance with the exchange ratio.[74]

However, this does not mean that whenever pre-emptive rights are excluded, the stringent requirements under Article 451 should be complied with. Under the following contexts, pre-emptive rights would not apply, and a distinction between these circumstances from what is envisaged in Article 451 is necessary.

5.3.1 In-kind contributions

Among the grounds of exclusion of pre-emptive rights, issuance of shares in return for non-cash contributions seems to be the most prevalent in a number of countries.[75] The 1960 Commercial Code provided this principle in a simple but indirect language. Stipulating the pre-emptive right of shareholders, Article 470(1) of the 1960 Commercial Code had stated that "shareholders shall have a preferred right of subscription of *new cash shares*, in proportion to the number of shares held."(*Emphasis added*). In such cases, "since cash is fungible, shareholders will pay the price set for the shares and acquire the new securities issued" proportionally.[76]

This exception being prevalent in many countries, it is justified on the needs of companies. "When the corporation wants to obtain property, such as land

[74] Ventoruzzo, *supra* note 19, p. 524.
[75] Cahn & Donald, *supra* note 5, p. 235
[76] Ventoruzzo, *supra* note 19, p. 531.

or real estate from a third party, or a business, the shareholders simply cannot offer to the corporation the same consideration that it is seeking to obtain".[77] From a practical point of view, "it is in this area of the law on pre-emptive rights that the conception of an equitable equilibrium of interests –the individual shareholder's and those of the body corporate– is most useful.'[78] This is because "the necessity or desirability of the corporation's owning the property must be weighed against the harm from dilution of stockholder interests".[79] As the owner of the property desired by the company may require shares of stock in exchange for the transfer, the company may have no option.

One may assume that the funds necessary to acquire the property can be raised through issuance of shares to the existing shareholders. However, it will not be feasible to issue shares to the stockholders for cash and then use the cash to purchase the property in situations where the property owner wants shares as the consideration. Or "the option or opportunity to purchase may be as limited in time as to preclude the ordinary delay arising from an offering period".[80] Here, "the interest of the company to receive exactly the property it seeks to acquire trumps the interest of the shareholders not to be diluted".[81] Thus, in many jurisdictions the exclusion of pre-emptive rights in case of non-cash contributions is either mandatory or a default rule.[82]

The in-kind consideration exception to the pre-emptive rights is not however free from controversies in as far as what constitutes non-cash contributions is concerned. For instance, where new shares are to be issued as a payment of debt owed by the company, the characterization of the consideration as an in-kind one may be controversial. In some jurisdictions the exception has been extended to shares issued in payment of corporate debt.[83] Such would be unconvincing as it is pretty artificial to distinguish such consideration from sale of shares for cash. In particular where the company cannot show that it is impractical to raise the funds needed to pay off the debt by selling shares to existing shareholders, it would not be acceptable to exclude pre-emptive rights of shareholders in such circumstances.[84]

[77] Ibid.
[78] Feliciano, *supra* note 54, p. 486.
[79] Id. at 487.
[80] Ibid.
[81] Ventoruzzo, *supra* note 19, p. 531.
[82] Hay, *supra* note 58, p. 29
[83] Feliciano, *supra* note 54, p. 490.
[84] Ibid.

Unfortunately, the Commercial Code of 2021 does not embody the in-kind contribution exception. Article 448(1) of the 2021 Commercial Code is the reproduction of Article 470(1) of the 1960 Commercial Code with the exception of deletion of the word 'cash' which used to qualify pre-emptive right to cash contribution under the 1960 Code. The deletion seems to be deliberate rather than a slip of the pen. This is apparent from the similarity of the Amharic and English versions of the provision both of which exclude reference to cash shares. As the wordings of the two versions are similar with the respective versions in the 1960 Commercial Code, it is clear that at time of drafting, the 1960 Commercial Code's provisions were reproduced with some edits. In any case, there is no any rationale for the deletion.

Exclusion of pre-emptive rights as a result of preference shareholders exercising preference as to subscription for new shares is more theoretical than practical. Even then, it seems to be peculiar to the Ethiopian Commercial Code.[85] This author's research of other laws and literature review could not identify any legal system in which preference as to subscription for future issue of shares is recognized. For example, the French Commercial Code does not recognize preference as to future subscription for shares. Nevertheless, Art. 279 of the Ethiopian 2021 Commercial Code (a reproduction of Article 336(1) of the 1960 Commercial Code) unambiguously stipulates that preference shares may "enjoy a preference over other shares, such as a preferred right of subscription in the event of future issues, or rights of priority over profits, or assets or both."

While preference as to future subscription for new shares is uncommon, it is also impractical. It is unthinkable for founders, and/or ordinary shareholders to give preference as to subscription for passive external investors. How can founders/promoters market the ordinary shares if they have such a stipulation in the prospectus? The opposite would rather be the more practical reality; that is, preference shareholders may be deprived of their right to subscribe for new ordinary shares. Hence, many countries provide for preference as to profits, distribution of assets at dissolution and preference as to voting. French Commercial Code –as revised in 2013 (Art. L-228-11)– allows preference shares to be created in the constitution of companies. However, this author has not come across any law that provides for preference as to subscription

[85] For instance, the International Encyclopaedia of Comparative Law does not mention preference as to subscription for future issue of shares; even though it discusses preference as to dividend, assets distribution and voting rights. See Vol. XIII/1, Chapter 5, p. 103.

for further shares. The law is rather prevalently interpreted as preference as to profits, assets or as to voting.[86]

Ethiopian law is not free from further controversy on the subject. Art. 453 of the 2021 Commercial Code prohibits preference as to subscription for new shares. It states “no documents conferring a preferred right of subscription may be issued.” Apparently, this provision contradicts with Article 279 as regards preference as to subscription. However, it may be interpreted that the prohibition under Art. 453 relates to documents other than the Memorandum of Association that create preference. Be that as it may, the legislative intent to limit the exercise of pre-emptive rights in favor of preference shareholders seems untenable.

5.3.3 Sale of treasury shares

Treasury shares are shares previously issued by the company and later on acquired by it through share redemption scheme or share buy-back. Ethiopian law clearly provides the conditions under which a company can redeem (repurchase) its shares, and corporate statutes often provide for such a mechanism. Article 275 of the Commercial Code provides the conditions of repurchase by a company of its own shares. The conditions include approval of the general meeting of shareholders, source of the purchase price coming from the net profits, and full payment of subscription in respect of the shares to be redeemed. These conditions seem to be inspired by considerations of maintenance of capital.

There are no direct and clear provisions relating to how such shares are transferred by the company, in particular the applicability pre-emptive rights of shareholders. Here it is important to recognize that companies can cancel such shares and reduce the capital accordingly. However, an issue would arise whether pre-emptive rights apply if a company chooses to transfer the shares to others. Faced with this question, a US Court had once declared that “the shares had continued to exist, and having ‘by hypothesis’ once been issued, they had diluted the voting power of the shareholders *ab initio*. Their resale gave rise to no pre-emptive rights since that merely restored the status the shareholder had originally accepted”.[87]

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[86] Pierre Henri Conac (2005), “The New French Preferred Shares: Moving towards a More Liberal Approach” *ECFR* 4/2005, p. 487-511. It is commendable that Ethiopian law does not allow preference as to voting- See Article 279(2) *cum* Articles 383, 384.

[87] Feliciano, *supra* note 54, p. 497.

However, one cannot argue that sale of treasury shares to existing shareholders in proportion to their shareholding will make no difference. As the proportional interest of each shareholder is determined by reference to the number of the remaining shares in the hands of others, a proportional sale of treasury shares to each shareholder can increase their relative shareholding while decreasing the number of outstanding shares.[88] Hence sale of treasury shares by the company at the board's discretion is not merely reinstatement of the shareholders to their previous position; it is a diversion of a right which if it had gone to the shareholders would have made a difference.

Therefore, the discretion of the board in transferring treasury shares is not inconsequential. It is often recognized as valid only where it serves legitimate corporate objectives[89] such as the company's financing needs, prevention of future deadlock between factions of shareholders, inclusion of key expert into the company, etc. In contrast, where it is shown that directors issue treasury shares to one group of shareholders or outsiders with the intention of transferring or reducing control rights of one or the other group without any legitimate benefit to the company, or where the benefit to the company can be realized through a means other than denial of pre-emptive rights, courts in other jurisdictions have disallowed the exclusion of pre-emptive rights during sale of treasury shares.[90] Therefore, in the absence such malicious intention, the "only protection that shareholders have, in this case, concerns the possible damage to the value of their investment if the treasury shares are sold for less than their actual value".[91]

The stipulation relating to pre-emptive rights under Articles 291(4) and 448 of the Ethiopian Commercial Code expressly refer to new issue of shares during capital increase. Admittedly, the act of reissuing treasury shares does not fit into this situation, i.e., treasury shares are not shares issued for increasing the capital. The provision closer to the situation of treasury shares is the sale of shares of members who fail to meet calls on shares as per Article 289. Under this provision, it is provided that where a shareholder fails to pay outstanding installment on the price of the shares, the company can sell the shares by auction. Based on this provision, one can gather that, in such cases the law is concerned more with the price at which the shares are to be sold than the pre-emptive rights of shareholders.

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[88] Barbara G. Edman (1976). "Treasury Shares and Pre-emptive Rights: Schwartz v. Marien", 26 *Buss. Law Review*, 154.

[89] Id. at 149.

[90] Ibid.

[91] Ibid.

5.3.4 Replacement of convertible debentures with shares

Issuance of convertible debentures affects pre-emptive rights of shareholders in as far as it implies that at some future date the capital of the company may increase by the amount of the debentures; and existing shareholders may suffer dilution to that extent. Therefore, taking this into account, Article 452 of the Commercial Code provides stringent conditions for the issuance of convertible debentures. It should be approved by the extra-ordinary meeting of shareholders with an express renunciation by the shareholders of their pre-emptive right for future subscriptions. In addition, like in the case of Article 451 discussed above, directors' report is required and auditors need to provide a special report before convertible debentures are issued.

6. Conclusions

The two most controversial issues in respect to capital increase are: (i) the power to decide on the increase; and (ii) the rights and protections provided to shareholders during the increase. There is the need to achieve efficiency in the first, and fairness in the second. Unfortunately, fairness and efficiency may not mutually reinforce each other. Yet, striking the right balance between the two is not only necessary, but it is also the foundation of an effective corporate governance that can serve as the bedrock of corporate growth and profitability.

From efficiency point of view, procedures and requirements that are set out to protect shareholder rights should not hamper growth of companies thereby resulting in the abandonment of external financing opportunities because of pre-emptive rights of shareholders which would not be exercised without substantial delay. However, Ethiopian law gives unbalanced protection to preemption rights. While preemption rights of existing shareholders are important, the law should be flexible enough to accommodate urgent financing needs of companies. From this perspective, the law should admit wider exceptions to preemption rights such as contexts that involve in-kind contributions, extraordinary general meeting delegation to the board of directors to implement capital increase resolutions, and sale of treasury shares.

Equally significant is the need to protect shareholders against dilution. The greatest danger of capital increase to non-participating shareholders is dilution. Here preemption right should not be taken as the only protection. Fair pricing of shares should also be considered as an alternative remedy where pre-emption rights need to be bypassed in the interest of efficiency. Moreover, more innovative agreements in corporate statutes that aim to balance efficiency with shareholder protections should be accepted in shareholder agreements and memoranda of associations. ■

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