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**THE DOCTRINE OF PIERCING THE CORPORATE VEIL: ITS LEGAL
SIGNIFICANCE AND PRACTICAL APPLICATION IN ETHIOPIA**

BY: ENDALEW LIJALEM ENYEW

**ADDIS ABABA
JUNE 2011**

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BY: ENDALEW LIJALEM ENYEW

ADVISOR: ZEKARIAS KENEEA (ASSOCIATE PROFESSOR)

**A THESIS SUBMITTED IN PARTIAL FULFILLMENT FOR THE
REQUIREMENT OF MASTER'S DEGREE IN BUSINESS LAW (L.L.M)**

**ADDIS ABABA
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(Approval Sheet)

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Declaration

I, the undersigned, declare that this thesis is my original work and has not been presented for a degree in any other university and that all sources of materials used in the thesis have been dully acknowledged.

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Dedicated to my grand parents

"Yikanu Lijalem."

Abstract

Business can be run through the medium of different forms of business organizations one of which is a company or a corporation. A corporation, once acquired its legal personality, enjoys certain attributes which differentiate it from other forms of unincorporated business organizations like partnerships and joint ventures. Among the attributes of a corporation, the separate legal personality and limited liability of a corporation makes it the chosen mode of business form.

The attribute of separate legal personality amplifies the fact that, in the eyes of the law, a company is a person capable of enjoying rights and assuming obligations quite different from the physical or juristic persons who brought it into existence or who may be its members at any given time. The rights and obligations of the individual members are not those of the company and vice versa. The other attribute of a company is limited liability of share holders in which the company will alone be liable for the debts it incurs. That is, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their own private funds.

The attribute of limited liability of a corporation is known as the veil or shell of incorporation, due to the protection it offers to the share holders by protecting or keeping them from the reach of outsiders (creditors). However, such privilege of limited liability may not always exist for some reasons including when the legal personality of a company is abused and used for illegitimate or unlawful purposes. If it is shown that the legal personality has been abused and used to the detriment of third parties (creditors), the theory of legal personality will be disregarded and it is looked upon as a collection of persons instead of a collection of capital. Consequently, the individual member (s), director (s) and manager (s) will be held liable for the wrongs caused through the use of the legal entity. This process is known as piercing or lifting the corporate veil.

This work studies the grounds by which the corporate veil can be pierced under Ethiopian law and the role of courts in applying the doctrine after making a short survey of the common law, where the doctrine got its origin, and civil law legal systems. The study was conducted based on legislative analysis, interview, and case analysis. The findings of the study show that there are many possible statutory grounds of piercing the corporate veil and that judges also have certain degree of discretion in applying the doctrine of piercing the corporate veil in the interest of justice. Finally, this work suggests some recommendations which the writer thinks to be appropriate.

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Abbreviations and Acronyms

PLC	Private Limited Company
S. Co.	Share Company
C.C	The Civil Code of Ethiopia
Com. Code	The Commercial Code of Ethiopia
Proc. No.	Proclamation Number
MoTI	Ministry of Trade and Industry
ETB	Ethiopian Birr
SARL	Societe A Responsabilite Limitee
SA	Socitie Anonyme
LLC	Limited Liability Company
E.C	Ethiopian Calendar
CEO	Chief Executive Officer
IRD	Inland Revenue Department
MoCI	Ministry of Commerce and Industry
OHADA	The Organization for the Harmonization of Business Law in Africa

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- Annex-3 W/rt. Feven Zemen and Others V. Askaluka PLC and Others, (Federal High Court, Civil File No. 96230, 2003 E.C), Statement of Claim and Decision of the Court.
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CHAPTER ONE

1. INTRODUCTION

1.1. Background of the Study

One of the fundamental features of company law is the fact that a company is a separate entity, distinct from its shareholders. When a company complies with the requirements for its formation, the law considers it as a person capable of enjoying rights and assuming obligations quite distinct from the members of the company.

Under Ethiopian law, legal personality is acquired by fulfilling the various requirements of the commercial code upon registration and publication in the commercial Gazette.¹

When a company acquires legal personality, there are essential attributes attached to it. Some of the attributes include that the company will acquire its own name, it can enter into contracts, hold and administer property in its own name, incur liabilities, can sue and be sued and perform other juridical acts in conformity with the law. Similarly, as the company is a legal person separate from its shareholders, the latter will not be liable for the company's debts so long as they have paid their subscribed shares. In this respect the share companies and private limited companies differ from partnerships in that the latter do not enjoy limited liability.²

The doctrine of separate legal personality and limited liability encourage entrepreneurship, by shifting the risks of business failure away from entrepreneurs to creditors and other risk bearers.³

However, the doctrines of separate legal personality (that is the separate and distinct existence of the company from that of its members) and limited liability may be disregarded and the company is considered as a collection of persons instead of a collection of capital in certain circumstances including when the legal personality is used

¹ Commercial code of the Empire of Ethiopia, 1960, Negarit Gazeta, proc. No.166/1960, year 19, No.3, Art. 223, 324,520

² Ibid, Arts. 255, 280, 296

³ Mohammed Reza salim, 'Corporate insolvency: separate legal personality and directors' duties to creditors', *Universiti Teknologi MARA Law Review*, Vol. 2, No. 90, 2004, p.1

for improper conduct which is detrimental to third parties.⁴ Consequently, the director (s), the manager (s) and the shareholder (s) will be held liable for the debts and liabilities of the company. This process is called “piercing the corporate veil” or “disregarding the corporate entity” or “lifting the veil” or “breaching the wall of incorporation”⁵ and it may be either judicial or statutory.

The very purpose of this research is therefore, to exhaustively examine the application of the doctrine of “piercing the corporate veil” in Ethiopian laws and its practical application in the courts after having a brief survey of the doctrines in the foreign jurisdictions, both the common law and civil law legal systems.

1.2. Statement of the Problem and Research Questions

As stated above, a corporation is an entity quite separate and apart from the individual shareholders and hence the shareholders will not be liable for the company’s debts so long as they have paid their subscribed shares. Though limited liability is an advantage for share holders, it may greatly affect the traditional debtor-creditor relationships. Limited liability can have negative effects on creditors in different ways.

First, it opens opportunities for both express and tacit misrepresentation in transactions with creditors. Share holders who employ the corporate form through which to contract with others may misrepresent the assets within the corporation and simply walk away if the business fails.⁶ Second, limited liability makes it possible and sometimes attractive to shift assets out of the corporation after a creditor has extended credit to the corporation. It would be simple to shareholders to distribute assets to themselves- particularly in case of one man and closely held companies-while leaving the debts with their corporation in violation of creditors’ right. Or more subtly, shareholders or directors

⁴Ottolenghi, S., ‘From Peeping behind the Corporate Veil, to Ignoring it Completely’, *the Modern Law Review*, Vol. 53, No. 3, Blackwell publishing, 1990, p.338

⁵ Chon E. J and Simitis, C., ‘Lifting the veil in the company laws of the European continent’, *International and Comparative Law Quarterly*, Vol. 12, No. 1, Cambridge University press, 1963, p. 190

⁶ Allen William T., Kraakman Reinier, and Subramanian, *Commentaries and cases on the law of business organizations*, (2nd ed.), Aspen publishers, New York, 2007, p. 131

may undertake highly risky (volatile) investments or increase leverage in order to shift uncompensated risk on to the shoulders of creditors.⁷

All of these and other opportunistic moves would lose much of their appeal if share holders did not have the shield of limited liability to protect their personal assets from the consequences of contractual default on the part of the corporation. To this end, courts, particularly the common law courts, apply the doctrine of “piercing or lifting the corporate veil” to make share holders and directors, or managers liable to third party creditors.

To pierce the corporate veil, common law courts use different grounds: A disregard of corporate formalities, thin capitalization, unity of interest and ownership that the separate personalities of the corporation and individuals no longer exist, in case of parent-subsidiary companies if corporations are not operated as separate entities but rather integrate their resources to achieve a common business purpose, and if adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice, are some, among plenty, of reasons to pierce the corporate veil.⁸

Under Ethiopian law, corporations have distinct corporate personality and liability and shareholders are liable only to the extent of their share holdings. According to Art.304 of the Commercial Code, liabilities of a share company are met only by the assets of the company and the liabilities of the corporate entity of a share company are limited to the total value of its assets.⁹ Hence, the shareholders of a share company are liable only to the extent of their share holding.¹⁰ Once the shareholder paid the par value and any premium agreed, he is no longer liable to contribute anything further towards meeting the company’s debts and liabilities. However, Ethiopia, like other countries provide an exception to the rule of separate personality and limited liability.

The pioneering work of Seifu Tekle Mariam founds out that the only statutory grounds of piercing under Ethiopian law is in case of bankruptcy.¹¹ That is, if a share company

⁷ Ibid, p.132

⁸ Ibid, pp.151-152

⁹ Supra note 1, Art. 304 (1)

¹⁰ Ibid, Art.304 (2)

¹¹ Seifu Tekle Mariam, *Piercing the corporate veil: its application to private limited companies and share companies in Ethiopia*, Senior Thesis, Faculty of Law, Haile Selassie I University, 1968, p.22

and/or private limited company is declared bankrupt and the assets are shown to be inadequate to meet its debts, the adjudication may declare bankrupt any person who has carried out commercial operations on his own behalf and disposes of company funds as though they were his own and concealed his activities under the cover of such company.¹² Though this provision has extended such liability to any person subject to the fulfillment of the conditions stipulated by the law, it does not tell us about who these persons are. Is it possible to make any person liable and declare bankrupt though he/she is not personally trader in contrary to Art. 968 of the commercial code?

The other logical question that follows is also, is bankruptcy the only statutory ground of piercing in Ethiopia? Is there no other statutory hole which is capable of giving a room for piercing the corporate veil? Couldn't the Ethiopian judges pierce the corporate veil in the interest of justice even though there is no clear statutory hole?

In this connection, there are arguments as to whether the doctrine of piercing is the ground when personal and unlimited liability for the company's obligations is imposed upon every shareholder if the company continues to trade with fewer than the required minimum number of members. The other point worth mentioning and controversial is the fact of making directors and shareholders liable for defective formation- like under capitalization, defect in agreement etc- of a share company. Putting it in a different way, could the creditors affected by the defect in formation claim from the personal assets of the shareholders and/ or the directors by piercing the veil on top of applying for dissolution?

Similarly, those who have been managing the affairs of the company, as directors may be held liable towards third party creditors where the directors have failed to preserve intact the assets of the company which leads to insufficiency of the company's assets to meet corporate liabilities.¹³

Regarding PLCs, Art. 510(1) of the Commercial Code provides that a private limited company is a company whose members are liable only to the extent of their contributions. Though the legislator jumped over to providing for liabilities of members instead of first providing for corporate liability, it is obvious that corporate liability is

¹² Supra note 1, Art. 1160

¹³ Ibid, Art. 366

understood in PLCs as well. However, Art. 531 of the Commercial Code provides that where in bankruptcy the assets are shown to be inadequate, the court may order that the managers, the member or both to pay the company's debts. This seems that piercing is a guiding principle in this regard. But, it is not clear as to whether the doctrine is equally applicable to appointed member managers and employed non-member managers. Equally important point is as to whether the above doctrine can be applied where a private limited company is not declared bankrupt but the assets of the company happens to be inadequate to satisfy the claims of creditors.

Further, though our Commercial Code recognized parent-subsidary relationship of companies in its requirement of registering the shares of the director of the company in its subsidiary or in other company to which it is subsidiary;¹⁴ in its prohibition of auditors from becoming a manager or a director of the parent or subsidiary of the company which they audit;¹⁵ in its call for extension of investigation to the affairs of holding and subsidiary company;¹⁶ in its requirement for submission of the accounts of the subsidiaries at the general meeting of the shareholders of the company if the latter is a holding company,¹⁷ the law is not clear on the issue of piercing the corporate veil in parent-subsidary companies. Similarly, though the law gives recognition to the other forms of group companies, i.e. sister-brother companies, there is no clear stand as to whether piercing is possible to make the other companies liable if one of the sister-brother company becomes unable to meet its debts.

A detail study was not conducted so far to examine the above controversial issues in relation to the doctrine of piercing the corporate veil in Ethiopia. Hence, this study attempts to exhaustively examine the application of the doctrine of "piercing the corporate veil" in Ethiopian laws, by making a further discovery of other possible statutory grounds with a view to resolving the above controversial issues, and its practical application by the Ethiopian courts.

¹⁴ Supra note 1, Art. 360 (1)

¹⁵ Ibid, Art.370

¹⁶ Ibid, Art. 384

¹⁷ Ibid, Art. 451

To achieve this purpose the research questions are designed as follows:

- What are the possible statutory grounds of piercing the corporate veil under Ethiopian laws?
- Do the Ethiopian courts apply the doctrine of piercing the corporate veil? How?

1.3. Literature Review

A corporation is an entity quite separate and apart from the individual shareholders. The recognition of the distinct personality of a company from the shareholders, as one of its defining element, goes back to *Salomon v. Salomon & Co. Ltd.* where it was decided that:

*"The company is at law a different person, altogether, from the subscribers to the memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or the trustee for them. Nor are subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the act."*¹⁸

As a result of separate legal personality, the shareholders are liable only to the extent of their share holding. Accordingly, creditors of the company could not seek satisfaction for their claims from the shareholders of corporate entity. The shareholders are normally shielded by the corporate shell of the company and they are liable only to the company to pay what they have agreed at the time of subscription.

However, under certain circumstances, the liability of the company may be extended to the director (s), manager (s) and shareholder (s) of the company in certain circumstances including when these individuals abuse the corporate limited liability advantage. Such is the principle of 'lifting the corporate veil' which refers to the possibility of looking behind the company framework (or behind the company's separate personality) to make the members and officers and shareholders liable.¹⁹ In other words, it is the judicial act of imposing personal liability on otherwise immune parent

¹⁸ Dov ohrentenin, Radcliffe Chambers, *Lifting the corporate veil*, p.2, available at: <http://www.radcliffechambers.com/articleDocs/374.pdf>

¹⁹ Miller and Jentz, *Business Law Today*, (8th ed.), Thomson west, USA, 2008, p.771

corporations, director (s), manager (s) and shareholder (s) for the corporation's wrongful act.

Though a great deal of literature have been written about the circumstances under which the corporate entity is pierced, a consistent guiding principle has not yet evolved to govern the numerous cases in which the legal entity was disregarded or pierced. That is why the well known author, Rogers AJA, has described the authorities for piercing the corporate veil as "incoherent and unprincipled" stating:

*"There is no common, unifying principle, which underlies the occasional decision of the courts to pierce the corporate veil. Although an ad hoc explanation may be offered by a court which so decides, there is no principled approach to be derived from the authorities."*²⁰

In relation to piercing the corporate veil, common law courts have many to say. A rationale for piercing corporate veil as set forth by the Texas Supreme Court in a certain decision is to protect individual and corporate creditors if the share holders themselves disregard the separation of the corporate enterprise by their acts.²¹

The Pennsylvanian Supreme Court, too, in holding a shareholder liable for the debts of a company, stated that:

*"The legal fiction that a corporation is a legal entity separate and distinct from its shareholders was designed to serve convenience and justice, . . . and will be disregarded whenever justice or public policy require and where rights of innocent parties are prejudiced or the theory of the corporate entity rendered useless . . . whenever one in control of a corporation uses that control, or uses corporate assets, to further his or her own personal interests, the fiction of the separate corporate identity may properly be disregarded."*²²

Similarly, the English law under its insolvency act provides for the liability of the parent company which, being a director of the subsidiary and being aware that the company

²⁰ Rams Ian M., and Noakes David B., 'Piercing the corporate veil in Australia', *Company and Securities Law Journal*, Vol.19, 2001, p.4

²¹ 'Piercing corporate veil under Indonesian law', *INA Magazine*, Vol. XXXI, No. 1, 2009, p. 27 available at: <http://www.ina.or.id/inaweb/files/legal.pdf>

²² 'Shareholders liability for the debts of the corporation, p. 3, available at: http://mayandmay.com/newsletters/update_11-07_corporate_veil.pdf

would go in to liquidation, failed to take every step that reasonably would have minimized potential loss to the latter's creditors.²³

Moreover under French law, Managers, directors, whether defacto or dejure, may be held liable individually and severally for the bankruptcy if the loss is attributable to their mismanagement. The issue of their liability comes in to picture in case they have treated the assets of the company as their own assets; carried out transactions in their personal interest under the cover of the company; carried on the business in their personal interest, despite the company's state of financial hardship, in a manner that led the company eventually to cease making payments; used the corporate assets or credit to their own interest at the expense of the company; engaged in fictitious accounting or book-keeping contrary to legal requirements; misappropriated or concealed corporate assets fraudulently.²⁴ Further, the French law, clearly stipulates for the liability of the parent company to the creditors of the subsidiary where the former, being appointed as a director or acting as a director by itself, causes the insolvency of the latter by disposing the assets as if it were its own; using the subsidiary as a mask to achieve its own purposes at the expense of the latter; failing to keep proper account of the subsidiary's affairs or exploitation of the subsidiary in a way that leads to its bankruptcy.²⁵

Generally, there are different theories dealing with corporate piercing and upon which courts consider as a ground to apply the doctrine. Some of the theories include the theory of agency, theory of fraud, theory of sham or façade, theory of group enterprise (single enterprise), the alter ego theory and theory of justice.²⁶

The Ethiopian Commercial Code confers legal personality to all business organizations except joint venture upon the fulfillment of all legal requirements. However, unlike

²³Yitayal Mekonnen, *The Legal and Institutional Framework Governing Company Groups in Ethiopia and the Current Practice*, Faculty of Law, Addis Ababa university, 2009 , p.42

²⁴ Kenneth weissberg and Marie-Caroline Moissinac of Lette & Associés, 'Piercing corporate veil in France', *International financial law review*, 1987, P.29, available at: <http://www.wgzavocats.com/articles/piercing-the-corporate-veil-in-france.pdf>

²⁵Supra note 21,p. 50

²⁶Supra note 19, p. 27

partnerships, it is only the companies that have complete legal personality separate from the owners. As the legal personality of partnerships is intertwined with the individual partners, the liability of the partnership may be extended to be a liability for individual partners.²⁷

On the other hand, as a rule, shareholders of a share company and private limited company are liable only to the extent of their share shareholdings to the company²⁸and they are not personally liable to third parties where the company fails to pay its debts.

However, there are certain statutory and judicial grounds by which the veil of the corporation can be pierced and so that the director (s), manager (s) and the shareholder (s) can be liable for the debts of the company.

Though a sole and pioneering study was made, by Seifu Tekle Mariam, to discover the application of the doctrine of piercing the corporate veil in Ethiopian share companies and private limited companies some forty years back, it was not exhaustive and only related the application of the doctrine of piercing the corporate veil to bankruptcy cases. Moreover, different socio-economic developments are witnessed and a rapid establishment of companies is a fashion of a day in Ethiopia.

Therefore, this study aims to exhaustively explore the application of the doctrine of piercing the corporate veil in Ethiopian laws through further discovery of other possible statutory grounds of piercing and its practical application in courts.

1.4. Objectives of the Study

1.4.1. General Objectives

The main objective of the study is to exhaustively examine the application of the doctrine of “piercing the corporate veil” in Ethiopian laws and its practical application by Ethiopian courts after making a survey of the doctrine in the common law and civil law legal systems.

²⁷ Supra note 1, Art. 255 (2), 280(1), 296

²⁸ Ibid, Art. 304 (2), Art. 510(1)

1.4.2. Specific Objectives

The study is designed to achieve the following specific objectives:

- To make a short survey of the application of the doctrine of piercing the corporate veil in the common law and civil law legal systems.
- To assess the doctrine of piercing the corporate veil in the Ethiopian legal framework.
- To explore the practical application of the doctrine of piercing the corporate veil by Ethiopian courts.

1.5. Significance of the Study

This study is considered to have its own academic and legal significance. It is hoped that it would initiate further study on the subject matter as it is unexplored area of law. Moreover, it would give lessons to the legislator to provide enough statutory exception to the doctrine of separate legal personality and limited liability and to the judiciary to be pro-active and follow the doctrine of piercing the corporate veil, as a guideline, to protect the interests of third party creditors when individuals improperly use the corporate shield.

1.6. Scope of the Study

The study focuses on the assessment of the doctrine of piercing the corporate veil in private companies and it does not apply for public enterprises. This is because, though public enterprises are formed under and governed by the provisions of the Commercial Code, their formation has not always been dictated by profit making but rather provision of public utilities. Moreover, though arguments are raised to the fact that the doctrine of piercing the corporate veil also applies in criminal matters, this study concentrates on matters of civil and commercial debts or commitments.

To assess the doctrine of piercing in private companies, the study mainly bases itself on the close analysis of the Ethiopian Commercial Code, other related laws & literatures and the analysis of decided real cases related to the issue.

1.7. Methodology of the Study

In the course of the study the researcher employed qualitative Methodology²⁹. To this end, the researcher used two approaches. First, he analyzed legal provisions of the Commercial Code and other related laws. He also looked into other published and unpublished literatures in the area. Thus, the Commercial Code provisions and other laws that have to do directly or indirectly with the issue, books, journals, case reports etc were reviewed and some decided real cases were analyzed.

Secondly, first hand information was obtained from the members of the judiciary, particularly from judges of the Federal Supreme and High Courts selected using purposive sampling technique,³⁰ in the form of interviews. The methodology that was employed, therefore, is an inter play of both primary and secondary sources. Finally, the information gathered from primary and secondary sources was compiled in the ways that is easy to manage and was analyzed and interpreted qualitatively using narrative technique.

1.8. Limitation of the Study

The researcher, in the due course of the study, faced different challenges and obstacles. These obstacles, among others, include shortage of time and budget, difficulty of easily finding the interviewees as they were occupied by different responsibilities and difficulty of finding the appropriate case to the issue at hand due to traditional and unmodernized case handling system of Ethiopian courts. The fact that some cases are still pending also has its own impact as the author is not able to get access to the cases. Yet, the writer believes that the cases analyzed and attached in this work can depict a certain picture about the role and stand of courts in the issue at hand.

²⁹ The researcher chooses this methodology because it is the most suitable way for addressing the research questions of the study, its high degree of flexibility and the fact that the study needs acquiring deep information from the informants.

³⁰ Purposive sampling technique is chosen as it enables the researcher to acquire qualified information from selected individuals based on their experience, position, expertise and other attributes the study so requires.

1.9. Organization of the Paper

This Study comprises of five chapters. The first chapter is an introductory chapter consisting of background of the study, statement of the problem and research questions, objective, scope, significance, limitations and methodology of the study. The second chapter deals about the general conception of a corporation and the doctrine of piercing the corporate veil followed by chapter three that makes a short survey of the application of the doctrine of piercing the corporate veil in the common law and civil law legal systems. Chapter four devotes on the exploration of the legal significance and practical application of piercing the corporate veil in Ethiopia. Lastly, chapter five concludes the findings and forward some recommendations based on the study results.

CHAPTER TWO

2. GENERAL CONCEPTION OF CORPORATION AND THE DOCTRINE OF PIERCING THE CORPORATE VEIL

2.1. GENERAL CONCEPTION OF CORPORATION

2.1.1. MEANING AND ORIGIN OF THE CONCEPT OF CORPORATION

The word corporation is derived from the Latin word '**corpus**' meaning body or person.³¹ The Romans identified a collection of persons considered as a 'corpus' or body out of which the English word for corporations was developed.³²

The Black's law Dictionary defines a corporation as "an entity having authority under law to act as a single person distinct from the share holders who own it and having rights to issue stock and exist indefinitely... and has the legal powers that its constitution gives it."³³

Another definition of a corporation, given by the American Supreme Court Justice John Marshall, in the case Trustees Dartmouth College V. Woodward states that a corporation is " an artificial being, invisible, intangible, and existing only in contemplation of law."³⁴

Still another definition of a corporation originating from the common law literatures defines a corporation as "an association of persons to whom the sovereign has offered a franchise to become an artificial, juridical person, with a name of its own, under which they can act and contract and sue and be sued..."³⁵

³¹P.W. Duff, *Personality in Roman Private Law*, Oxford University press, London, 1971, p. 26

³²Ibid

³³Brayan A. Garner, *Black's Law Dictionary*, (9th ed.), West publishing Co., U.S.A, 2009, p.392

³⁴Blumberg Phillip I., 'The Corporate Personality in American Law: A Summary Review', *the American Journal of Comparative Law*, Vol. 38, Supplement. U. S. Law in an Era of Democratization, American society of Comparative Law, USA, 1990, p. 49

³⁵Bruck Kefyalew, *Lifting the corporate veil in corporate Groups Under the commercial Code of Ethiopia*, Senior Thesis, Faculty of Law, Addis Ababa University, 2003, p.3

A well known Indian author Gogna, P.P.S, has also defined a company as “a voluntary association of persons formed to achieve some common objectives, having a separate legal entity, independent and separate from its members, with a perpetual succession and a common seal, and with capital divisible in to transferable shares.”³⁶ This definition of a company, as we will see below, tries to enumerate the basic characteristics of a company.

Some also have defined the corporation more of as a technique than a legal person; the following definition is one;

*[A]corporation is merely a method than a thing and...the law in dealing with a corporation has no need of defining it as a person or an entity or even as an embodiment of functions of rights and duties but may treat as a name for a useful and usual collection of jural relations, each one of which must in every instance be ascertained, analyzed and assigned to its appropriate place according to the circumstances of the particular case, having due regard to the purposes to be achieved.*³⁷

Different jurists and writers have given out such definitions of a corporation. Each has provided its own understanding and view about what a corporation is in its own choice of words. However, it is not possible to have a single definition which is universally acceptable by all legal systems. In fact, most of the definitions given above indicate the different inclinations toward the nature of the corporation. While one definition indicates the corporation is a **being (entity)** others state that it is more of a **method** than a being.

Under Ethiopian law, though there is no definition of a company, it is possible to understand what a company is through its attributes.

The presence of various definitions of corporations is the result of the existence of the different theories of corporate legal personality, which influence the laws of states. The existence of a number of theories on legal personality of corporation influences lawyers, jurists and authorities in law making or decision making organs of states. This tends to create a spectrum of definitions of a corporation across various legal systems.

³⁶ Gogna, P.P.S, *A text book of Company law*, S. Chand & Company Ltd., Ram Nagar, New Delhi, 2004, p.9

³⁷ Supra note 35, p.4

2.1.2. THEORIES OF CORPORATE LEGAL PERSONALITY

There are various theories³⁸ of legal personality that try to explain the nature of the legal personality of a corporation. Each of these theories has a varying degree of influence on the modern concept of a corporation and different legal systems are influenced by these different theories and some legal systems develop their own approaches regarding a corporation based on these theories. However, these theories are not mutually exclusive and no single theory can be said to pre-dominate the others. Some of these theories include the **fiction theory**³⁹ of legal personality, the **contract theory**⁴⁰ of legal personality, the **realist (organism) theory**⁴¹ of legal personality and the **concession theory**⁴² of legal personality etc.

³⁸ Abraham Ayalew, in his thesis titled “criminal liability of bodies corporate” stated that there are about sixteen theories of legal personality that try to explain the nature of the legal personality of a body corporate.

³⁹ Hahlo H.R., *Company Law through the Cases: a collection of leading English and South African cases on company law together with explanatory notes and comments*, (2nd ed.), Juta & Company Ltd, South Africa, 1969, p. 1.

⁴⁰ Ibid

⁴¹ Ibid. The realist theory states that the body corporate has “**real personality**” in the extra judicial, prejudicial sense of the term.” Unlike the concession theory of legal personality, the realist theory states that a corporation is a reality and does not necessarily require state concession. It further states that human beings are physical organisms and bodies corporate are social organism. As human being has its members, the head and the limbs, and wills and acts through them, so does social organisms. Social organisms can will and acts through their members, which together form a corporate body. (See also Bruck Kefyalew, Lifting the corporate veil in corporate Groups Under the commercial Code of Ethiopia, p.9). The organism theory seems to have derived out of the terminology of the word corporation- “corpus”- meaning body. Hence, a corporation is seen as a body with a will of its own, in the organism theory. The organism theory focused on the presumption that all bodies corporate are results of associations or group of persons having real personality and will. The power of a social organism to will is a total product of the will of the members and the power of the body corporate to act, according to this theory, is the result of the power to act of its members. (See Harry G. Henn and Jhon R. Alexander, *Laws of corporations*, hornbook series, 3rd ed., west publishing co., 1983, p.146 cited below). However, the assumption that all legal persons are associations is not always correct as there is the so-called one man company.

⁴² Henn Harry G. and Alexander Jhon R., *Laws of Corporations*, (3rd ed.), Hornbook series, West Publishing Co., New York, 1983, p.145. The concession theory also known as “the fiat theory”, “government paternity theory”, “franchise theory” states that the state naturally has a power to exercise control over the right of associations and hence, decide which association is recognized as a legal unit and which is not. This theory places the issue of legal personality at the discretion of the state and does not try to inquire how one association gets personality and how another does not. This theory does not make the personality of bodies corporate as the right of the bodies nor does it state that bodies corporate are persons in their own virtue or by the creation of the law. In short, this theory placed emphasis on the fact that bodies corporate get their personality by grant or concession they get from the government whether by charter, act of parliament, or administrative act and as such associations, though not duly formed as legal persons by the procedure laid down in the law for this purpose, may be recognized as legal persons. (see also Hahlo H.R., *Company Law through the cases: a collection of leading English and South African cases on company law together with explanatory notes and comments*, Juta & Company Ltd, 2nd ed., 1969, cited above).

The fiction theory of legal personality and the contract theory of legal personality are discussed below in much detail due to their importance to the topic of the study, particularly in the context of Ethiopia. The detail analysis of these theories is crucial for the understanding of the doctrine of piercing the corporate veil as the doctrine is associated with the legal personality of a corporation and the advantages of limited liability. Hence, the theoretical explanation of the legal personality of a corporation is important to define the circumstances due to which the legal personality of a corporation comes to an end. The two theories of legal personality (fiction and contract theory) are discussed below in detail.

2.1.2.1. The fiction theory of legal personality

The 'fiction theory' also called the '**entity** theory' states that the only persons with real personality are natural persons and only they can be subjects of rights and duties, and whatever personality 'entities' enjoy is there only by the fiction of the law.⁴³ Accordingly, bodies corporate⁴⁴ are not persons in the ordinary sense of the word, they are however granted a fictitious personality by law. Human beings are persons by their very nature and draw their capacity for rights and duties by the mere fact of birth⁴⁵ or even sometimes by the factual anticipation of their coming to this world (by the mere fact of conception)⁴⁶. However, bodies corporate do not enjoy such privilege as they are not persons by nature. Their personality arises from the mere fiction of the law. Though, in reality, only human beings are persons and only they have the capacity to enjoy rights and assume obligations, the state has introduced bodies corporate as persons by virtue of the fiction of the law so that they can exercise rights and assume duties. Therefore, according to the fiction theory of legal personality, bodies corporate are ***persona ficta***,⁴⁷ **fictitious persons.**

⁴³ Abraham Ayalew, *Criminal liability of bodies corporate*, Senior Thesis, faculty of Law Addis Ababa University, 1998, p.5

⁴⁴ The terms bodies corporate, bodies politic, corporation and company are mostly used interchangeably. Hence, the terms are used in this paper to refer to the same thing.

⁴⁵ Civil Code of the Empire of Ethiopia, 1960, Negarit Gazette, Proc. No.165/1960, year 19, No.2, Art. 1

⁴⁶ Ibid, Art. 3

⁴⁷ Supra note 42, p.145

Initially, the fiction theory believed that corporations can only be perceived through the fiction theory and apart from the fiction of the law there is no such thing as body corporate.⁴⁸ Savigny, who is the founder of this theory, explained this belief saying that “the reality is there is no reality at all.”⁴⁹

However, later on, the works of jurists as Salmond and Maitland, who were supporters of Savigny, admitted to the existence of the body corporate as a **real existence** but only with fictitious personality.⁵⁰ The admission of the existence of bodies corporate as real could be well understood from the words of Salmond who said “the law creates legal personality by personifying some real thing.”⁵¹ Salmond further argued that bodies corporate have real existence and it is only their personality that is fictitious by saying “granting legal personality to a human being is granting legal power to a real will and granting legal personality to a body corporate is like granting legal power to an entity that has no mind and no will.”⁵² It is this assertion that all supporters of fiction theory believe that a body corporate is incapable of knowing, willing and acting on its own, but the law by granting legal personality makes it to be capable of knowing, intending, willing and acting. Accordingly, a body corporate is made capable by law to do things that it had no capacity to do.

Generally, it is accepted that corporate entity is not imaginary or fictitious but **quite real**, whereas corporate personality is a fiction whose origin is to be found in the psychological tendency towards personification.

Therefore, the fiction theory's position on bodies corporate as fictitious person was changed from **absolute fiction** of the law to really existing things which were given only fictitious personality to become a legal person. This position could be best illustrated by the fact that the law sets different requirements for acquiring legal personality-like minimum members and capital requirements- and if such requirements are not met or goes below the minimum requirements even after getting legal personality, the law does not allow it to exist, as clearly stipulated in the Commercial Code.

⁴⁸ Supra note 43, p.6

⁴⁹ Supra note 42, p.145

⁵⁰ Supra note 35, p.7

⁵¹ *ibid*

⁵² *Ibid*

Once acquired personality, a body corporate will enjoy rights and assume duties. It can possess and administer property, enter into contracts; it can sue and be sued etc.

According to the fiction theory, the corporation acts through its officers and board of directors to perform juridical acts as it has no soul or conscience.⁵³ Thus, through a sort of agency relationship, the fiction theory asserts that the corporation can acquire rights and bear duties. The argument that a corporation acts and wills through its officers or board of directors, that might be called its agents in a modified sense of the word, increases the coherence and clarity of the fiction theory.

2.1.2.2. The contract theory of a corporation

According to this theory, the corporation is a result of a contract among its members according to the law they have chosen to abide by⁵⁴. The corporate charter is viewed as a '**contract**' and thus the creation of the corporation is a result of a contract of the shareholders to work together for a certain purpose⁵⁵. Accordingly, share holders are under the duty to abide by the rules of the corporate charter. They are under duty to preserve the rights of other share holders, to be in good faith in the management and preservation of the corporation, which can be viewed as a joint property of the contracting parties.

Though the contract theory explains how a corporation is formed, it does not justify why it is given a legal personality. However, the theory influenced many countries laws including ours. In the Ethiopian Commercial Code, Art. 210 defined a corporation as an association arising out of a partnership agreement. Art. 211 of the Commercial Code in turn defined a partnership agreement as "a **contract** whereby two or more persons who intend to join together and to cooperate undertakes to bring together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out thereof, if any." ⁵⁶ This clearly shows that the Ethiopian law is influenced by the contract theory of corporate legal personality.

⁵³ Supra note 36, p.9

⁵⁴ Supra note 42, p.146

⁵⁵ Supra note 35, p.12

⁵⁶ Supra note 1, Art. 211

Generally, the various theories of legal personality of corporations help in outlining the attributes of corporation. Since each theory has strengths and weaknesses, no one theory is perfect. For what one theory fails to explain, another may offer a good explanation; plus no one theory proves to explain all things in an exhaustive manner. Hence, it is not proper to take up one theory and hold it as the guiding principle but to recognize its flaws and apply the theory along with the other theories in a manner that offers the best solution.

The approach of the Ethiopian law towards the nature of the corporation could be best explained as a **blend** of the fiction theory and the contract theory of the corporation. The influence of the contract theory can be seen in Arts. 210 and 211 of the Commercial Code which states that: business organizations (partnerships, joint ventures and companies) are associations arising out of partnership agreement, which is basically a contract. Hence, a corporation is considered as arising out of a contract which shows the inclusion of the contract theory in the conception of 'the corporation' in the Ethiopian legal system.

Regarding the influence of the fiction theory, Art. 210(2) of the Ethiopian Commercial Code states that "any business organization other than a joint venture shall be deemed to be a legal person." This statement is a reflection of the idea of the fiction theory that a corporation is deemed to be a legal person while it is not in fact. However, the legal personality of a corporation is to the extent of the purpose for which it is established. Moreover, the stipulation of Art. 216 of the Commercial Code that a corporation is acting, acquiring its rights and duties through its officers, who are referred to as its agents, reinforces the reflection of the fiction theory as discussed in the previous section.

Therefore, the legal personality of Ethiopian corporations is grounded on the contracts of share holders and the contemplation of the law. Hence, the use of the corporate personality to illegal ends will result in the contract to be invalidated and consequently no contemplation of legal personality will continue to exist.

2.1.3.ATTRIBUTES OF A CORPORATION

A corporation as a business organization enjoys certain characteristics (attributes), which differentiates it from other forms of business organizations like partnerships and joint ventures. Among the attributes of a corporation, the separate legal personality and limited liability make it the chosen mode of business form. These attributes of a corporation are discussed below in detail due to its importance to the study and due to the fact that the doctrine of piercing the corporate veil has much to do with these attributes.

2.1.3.1. Separate legal personality

When a company fulfils the requirements laid down for its formation, the law considers it as a person. That is, in the eyes of the law, it is a person capable of enjoying rights and assuming obligations quite different from the physical persons who brought it into existence or who may be its members at any given time.⁵⁷ The rights and obligations of the individual members are not those of the company and vice versa.

The House of Lords' decision in the case of Salomon V. Salomon & Co. Ltd [1897], in revising the decisions of the Higher Court and the Court of Appeal marked the beginning of the **judicial acceptance** of the company as a **separate legal entity**. The facts of the Salomon V. a Salomon & Co. Ltd are given below (as taken from Stephen Griffin, Company law: fundamental principles).⁵⁸

The facts of the Salomon case were as follows:

The proprietor of a small but successful business, Mr. Salomon, incorporated a business as a limited company in accordance with the registration provisions contained within the companies Act 1862. Section 6 of the 1862 Act provided that seven or more persons together could incorporate a business, provided that it was associated for a lawful purpose.

The seven subscribers to the Salomon & Co. Ltd were Mr. Salomon, his wife and their five children. The company, A Salomon & Co. Ltd, purchased Mr. Salomon's

⁵⁷ Supra note 11, p. 4

⁵⁸ Griffin Stephen, *Company law: fundamental principles*, (4th ed.), Pearson Longman, 2008, p. 6

business in a solvent state for a consideration to a value of approximately €39,000. Mr. Salomon received 20,000 a fully paid-up €1 shares, an issue of debentures to the value of €10,000⁵⁹. The remaining members of the family were each allotted a €1 share in the company.

Unfortunately, a Salomon & Co. Ltd did not prosper. Mr. Salomon's debentures were transferred to Mr. Broadrip in return for €5000; this amount was then pumped back to the company by Mr. Salomon. Despite further efforts on the part of Mr. Salomon to keep the company afloat, less than a year after its incorporation a company fall into an insolvent state. The company could not meet Broderip's debenture interest payments and, fearful that his investment would be lost, Broderip sought to realize his security (the floating charge) by appointing a receiver. The company, which had other creditors, was subsequently put into liquidation. The liquidation (resulting, ultimately in a sale of corporate assets) of the company's assets realized sufficient funds to meet the company's debt to Brodrip but not the debts owed to the company's other creditors who, unlike Brodrip, had no secured interest (debentures).

In the High court (heard as Broadrip V. Salomon [1895] 2 Ch 322), the liquidator admitted the validity of Broadrip's prior claim to be repaid from the company's assets- as holder of a secured loan he had priority. Nevertheless, the liquidator counter-claimed that the company and, therefore, the company's unsecured creditors were entitled to be reimbursed by Mr. Salomon personally.⁶⁰

The trial judge, **Vaughan Williams J**, agreed with this contention. Whilst admitting that upon its registration a company is a legal entity, distinct from its corporators, the learned judge opined that A Salomon & Co. Ltd (the company) was ***no more than an agent of its principal***, i.e. Mr. Salomon. As such, the principal was responsible for the debts of its agent. The basis for the agency argument was that a company was a mere alias of its founder and had not been formed in accordance with the true spirit of the 1862

⁵⁹ A debenture acknowledges a loan or other credit agreement between the company and its creditor and is normally secured against the assets of the company. In Salomon's case the debenture was secured by means of a floating charge and took the remainder of the sale price in cash.

⁶⁰ Supra note 58, p. 7

companies Act. **Vaughan Williams j** believed that the 1862 Act, in its requirement for 'seven persons associated for a lawful purpose' should be interpreted to mean seven persons with a **bona fide** intention of participating in a trading venture, and not, as in the present case, a company which, in reality, was akin to a one-man business.⁶¹

On appeal, the decision of Vaughan Williams j was upheld, although in the Court of Appeal's opinion the correct analogy between the company and Mr. Salomon was that of **trust relationship**: the company held its property on trust for its beneficiary, Mr. Salomon. As such, the creditors of A Salomon & Co. Ltd were entitled to claim against Mr. Salomon through the company. As the High Court, the court of Appeal recognized that A Salomon & Co. Ltd, in complying with the registration provisions of the 1862 Act, had been validly incorporated as separate legal entity. However, the court would not recognize that the liability of A Salomon & Co. Ltd should be divorced from that of its founder, Mr. Salomon. Because in common with the High Court, it agreed that in relation to the requirements of incorporation, the correct interpretation of the companies Act of 1862 was that seven persons who become members of the company should participate in the venture, rather than having but nominal and superficial interest.⁶²

Notwithstanding that the business had been profitable prior to its incorporation, **Lindley LJ** (the Appellate Court's judge) was of opinion that the manner in which the company had been formed indicated that it had been created for an illegitimate purpose, that it was a **device to defraud creditors** and as such was therefore contrary to the terms of the 1862 Act because it was not associated for lawful purpose. Indeed, in the Court of Appeal's opinion the company's illegitimacy stemmed from the fact that it was in reality a one-man company. Lopes LJ Stated:

*'If we were to permit it to succeed, we should be authorizing a perversion of the joint Stock Companies Act. We should give vitality to that which is a myth and a fiction... To legalize such a transaction will be a scandal.'*⁶³

⁶¹ Ibid

⁶² Ibid

⁶³ Ibid, p. 8

The House of Lords, in revising the decision of the Court of Appeal, rigorously denied the assertion by the lower courts that a company could not be formed by one dominant character together with six other persons divorced of substantial interest in the business venture. According to the House, the statutory language of the company's Act 1862 was clear. A company could be incorporated provided it had at least seven members, irrespective of whether all seven members made a substantial contribution to the company.⁶⁴

Although both the High Court and the Court of Appellate recognized that A Salomon & Co. Ltd, having complied with the registration provisions of the 1862 Act, was a corporate entity, they had not contemplated the fact that once incorporated the company could not be considered as anything other than an independent entity, totally separate and distinct from its founder, Mr. Salomon. The House of Lords' interpretation of the separate legal identity of a company was, in respect of A Salomon & Co. Ltd, absolute. Lord Macnaughten Stated thus:

*'The company is at law a different person altogether from the subscribers to the memorandum; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the act.'*⁶⁵

The House of Lords in considering the agency and trust arguments of the lower courts concluded that both were contradictory to the view that the company was a separate legal entity. The finding of the agency or trust relationship would have meant that Mr. Salomon would have been personally liable for the company's debt.

Lord Halsbury remarked:

*'once the company is legally incorporated it must be treated like any other independent person with rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.'*⁶⁶

⁶⁴ Ibid

⁶⁵ Ibid

⁶⁶ Ibid, pp. 9

It is this decision of the House of Lords that marked the beginning of the **judicial acceptance** of the company as a **separate legal entity** distinct from its members. However, the decisions of the High Court and the Appellate Court can be taken as exceptions to the separate legal personality of a company if the company is employed for improper ends (as will be discussed later in the section dealing with the doctrine of piercing the corporate veil).

Generally, a company is an independent legal person separate from its members. Under Ethiopian law, legal personality is acquired by fulfilling the various requirements of the Commercial Code of Ethiopia and upon publication in an official commercial Gazette⁶⁷. Once a company acquires legal personality, there are important consequences attached to it. Some of the consequences are: the company has its own name, nationality and place of residence; it can possess and administer property; it can enter into juridical acts in its own name, sue and be sued, has perpetual existence. These effects of separate legal personality are discussed below in more detail.

1. NAME

The corporation, once established, will acquire a name by which it is identified from other persons, be it natural or legal. Arts. 305 and 514 of the Commercial Code requires the share company and a private limited company respectively to have a name by which it is designated and indicating the nature of the company.

The choice of name for a company is of considerable importance and subject to a number of restrictions. To this end, Art. 305 of the Commercial Code states that ***“the company name shall be as agreed but shall not offend public policy nor the rights of third parties and shall include the words ‘share company’.”***

As can be seen from the above provision, there are some restrictions regarding the choice of the company's name though it still gives a freedom to choose the name of a company as per the agreement of the members. In other words, the company may not be registered with a name which, in the opinion of the organ empowered to register,

⁶⁷Supra note 1, Arts. 223, 323, 324. However, practically it does not exist as there is no commercial Gazette.

could offend public policy and the rights of third parties. To the name, there should also be attached the words “share company or S. Co.” for a share company and “private limited company or PLC” for a private limited company to make the nature of the business organization visible to third parties.⁶⁸

The other restriction on the selection of names is what we call it the rules of **passing off** -i.e. the prohibition of using an identical or a name so similar to the name used by an existing business as to be likely to mislead the public into confusing the two concerns.⁶⁹

Hence, a corporation will acquire a name, subject to restrictions, which represents the person of the corporation, the business and the good will of the same.

2. Capacity to enter into juridical acts

A corporation is capable to enter into juridical acts- acts which can produce legal effect. It can engage in activities important for the attainment of the business purpose for which it is established. Hence, it can enter into contracts or transactions of different types, it can possess and acquire property, sue and be sued in its own name and conduct many activities in the same way a natural person does except acts which are purely of personal nature, like taking oath, seeking election, marriage or divorce.⁷⁰ However, the rights and duties of a juridical person are restricted by the specific objectives or motives they are established for.

3. Nationality or residence

A corporation, like natural persons, has a nationality or residence of its own.

Although nationality of natural persons is usually easily determined, attributing nationality to corporations is a little difficult. Two principal tests have been applied for determining Nationality (foreignness or domesticness) of a corporation: (a) **the aggregate test**, looking to the nationality, domicile or residence of the individuals who

⁶⁸ Ibid, Arts. 305, 514 (2)

⁶⁹ Dine Janet, and Koutsias Marios, *Company Law*, (6th ed.), palgrave macmilan, Queen Marry, University of London, London, 2007, p. 17

⁷⁰ Supra note 36, p.9

control the corporation; and (b) **the entity test**, looking to the nation where it was incorporated or where it has its principal place of business.⁷¹ However, it is the second test (the entity test) which is mainly used to determine the nationality of a corporation- i.e. Nationality is determined based on its place of incorporation or place of business.⁷²

Hence, companies incorporated and registered outside Ethiopia are the nationals of that particular country where they are incorporated; whereas, companies incorporated and registered in Ethiopia will acquire Ethiopian nationality. However, a company may have several or multiple residences as it may operate by opening many branches.

Identifying the nationality or residence of a corporation is important in determining which law governs the activities of a corporation. Hence, companies which acquired Ethiopian nationality will be governed and regulated as per Ethiopian laws. Similarly, companies incorporated abroad, under foreign laws, and whose head office or principal business is in Ethiopia; or companies incorporated in abroad and which have subsidiary offices or branches in Ethiopia, with permanent representation shall be subject in respect of each office or branch to the Ethiopian commercial code and regulations made there under.⁷³

Therefore, corporations acquire the status of nationality or residence depending on the place where they are incorporated or where it has its principal place of business so as to determine to which legal sovereign they are subject to.

4. Possessing and owning property

The corporation can acquire and remain in possession and ownership of its own assets. This effect of legal personality of a corporation distinguishes it from other types of business organizations. In partnerships, the partnership property is commonly owned by the partners though the partnership has its own legal personality. However, the

⁷¹ Supra note 42, p.171

⁷² Sealy Len and Worthington Sarah, *Cases and Materials in company law*, (8th ed.), Oxford University press, London, 2008, p.46

⁷³ Supra note 1, Arts. 555, 556 (1)

corporation owns the cash, marketable securities, land or the right of use of the land, buildings, equipments and long term investments made in the company's name.⁷⁴

Holmes affirmed the fact that a corporation has a distinct property interest saying that "the corporation is a person and its ownership is a **nonconductor** that makes it impossible to attribute an interest in its property to its members."⁷⁵

Despite the fact that a person may have exclusively owned the property and asset of the business prior to its incorporation as a registered company, the property vested in the company belongs to the company; a share holder has no right of ownership in respect of the company's properties or assets.⁷⁶ While a company holds its property and assets for the ultimate benefit of the associated rights of its membership, a member of a company may still be convicted of theft from the company in which he is a member, notwithstanding that a member in question holds all or substantially all the shares in the company.⁷⁷

Hence, the corporation owns its own assets or properties from which its creditors can claim in times of debt.

5. Perpetual existence

The other attribute of separate legal personality of a corporation is its perpetual existence (succession). Once a corporation has been duly established, it enjoys an existence which is only dependent on its business success or failure, and not on the fate of its members. This means that even if the people running the company are continuously changing, the company itself retains its identity and the business need not be stopped and restarted with every change in the managers or members (share holders) of the business.⁷⁸ Blakstone reaffirmed this fact saying that "a corporation is a person in law, a person that never dies: in like manner as the river Thames is still the

⁷⁴ Supra note 35, p.18

⁷⁵ Roul Berger, 'Disregarding the Corporate Entity for Stockholders' Benefit', *Columbia Law Review*, Vol. 55, No. 6, Columbia Law Review Association, Inc., 1955, pp. 808-829, p. 809

⁷⁶ Supra note 58, p. 2

⁷⁷ Ibid

⁷⁸ Supra note 69, p. 21

same river, though the parts (tributaries) which compose it are changing every instant.”⁷⁹ Thus, the company remains unchanged and unaffected by changes in its individual membership without any need of adjustment that is crucial in other business forms for the existence of the business. That is, the death, insanity or insolvency of the members does not affect the corporate existence of the company in any way so long as the legal minimum remains intact.

However, it does not mean that corporations live forever once created. As a company is created by the process of law, it can also be brought to an end by the process of law. Thus, a corporation comes to an end when their owners decide to dissolve it or merge it with another business or dissolved as per other grounds provided by law.⁸⁰

Generally, a corporation is an entity quite separate and apart from the individual shareholders and hence it manifests the aforementioned effects.

2.1.3.2. Limited Liability of Shareholders

Limited liability of share holders is another attribute of a company which makes it the chosen mode of business. Since a company is a separate person with property interests, it will alone be liable for the debts it incurs. This means that, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company’s debts out of their own private funds. The shareholders are liable only to the extent of the amount they have paid, or have promised to pay, for their shares.⁸¹ The members will never pay more into the company than the full purchase price of their shares. Share prices need not necessarily be paid when they are first purchased. When some money is outstanding on shares, the company may issue a ‘**call**’ for the remainder to be paid, but it can never demand more than the full price due to the company for that share.⁸² Hence, a company is responsible for its own actions and will be predominantly liable for its own debts and the company’s creditors cannot seek satisfaction from the members even if the company’s funds (assets) are insufficient to pay its liabilities in full. Moreover, the members’

⁷⁹ Supra note 42, p.147

⁸⁰ Supra note 1, Arts. 217, 218, 495, 542, 543

⁸¹ Supra note 69, p.2

⁸² Ibid, p. 12

personal creditors had no right to the company's assets except to the extent of the debtor member's share.⁸³ However, it must be noted that the law does not prevent the companies from making the liability of its members unlimited through the express provisions of the articles of association.⁸⁴

The rule of Limited liability has a general application. It applies to all corporations regardless of the number of shareholders, the business in which they operate, or even whether they have business operations at all or merely function as a shareholding parent within a corporate group.⁸⁵

Under Ethiopian law, corporations have distinct corporate personality and liability and shareholders are liable only to the extent of their share holdings. According to Art.304 of the Commercial Code, liabilities of a share company are met only by the assets of the company and the liabilities of the corporate entity of a share company are limited to the total value of its assets.⁸⁶ The shareholders of a share company are liable only to the extent of their share holding.⁸⁷ Once the shareholder has paid the par value and any premium agreed, he is no longer liable to contribute anything further towards meeting the company's debts and liabilities.

Regarding PLCs, Art. 510(1) of the Commercial Code provides that a private limited company is a company whose members are liable only to the extent of their contributions. Though the legislature jumped over to providing for liabilities of members

⁸³ Supra note 5, p.189

⁸⁴ Bagrial, Ashok K., *Company Law*, (12th revised ed.), Vikas Publishing House Pvt. Ltd., New York, 2007, p.34. This is particularly true in case of Companies Limited by guarantee where the shareholders agreed to guarantee the debts of the company to a certain extent beyond their contribution, in case the company becomes unable to meet its debts. This possibility is not also totally closed even under Ethiopian law. This is because there is no clear prohibition from making the liabilities of shareholders unlimited through their mutual agreement as making the liabilities of shareholders unlimited is an advantage for third parties. However, in case of General Partnership, it is not possible to make the liabilities of partners limited by their article of association as the provision of the law is mandatory and as it would affect the interests of third party creditors.

⁸⁵ Cheng Thomas K., 'Form and substance of the doctrine of piercing the corporate veil', *Mississippi law journal*, Vol. 80, No. 2, 2010, p. 510

⁸⁶ Supra note 1, Art. 304 (1)

⁸⁷ Ibid, Art. 304(2)

instead of first providing for corporate liability, it is obvious that corporate liability is understood in PLCs as well.

In short, the members of a company assume only a limited liability (to the extent of their contribution or share holding) for the debts of the company. In this respect share companies and private limited companies differ from other forms of business organizations in that the latter do not enjoy limited liability.⁸⁸ Thus, this attribute of a corporation has greatly facilitated the expansion of business, particularly in the risky ventures. This is because limited liability encourages greater boldness and risk taking among the business community, so that new avenues to increasing commerce are explored which in turn provide employment and adds to the nation's economic and financial growth, stability and prosperity.⁸⁹

Since the liability of the members is limited to their contribution, the company's creditors cannot extend their hands to the personal property of the share holders. Hence, due to the protection it offers to share holders, the attribute of limited liability of a corporation is known as **the veil or shell of incorporation**. This is because this attribute covers the share holders in the corporate veil and keeps them from the reach of outsiders (creditors). The veil or shell is the corporate personality of the corporation and the share holders are under the veil of incorporation.

However, though limited liability is an advantage for share holders, it may greatly affect the traditional debtor-creditor relationships. Limited liability can have negative effects on creditors in different ways.

First, it opens opportunities for both express and tacit misrepresentation in transactions with creditors. Share holders who employ the corporate form through which to contract with others may misrepresent the assets of the corporation and simply walk away if the business fails.⁹⁰

⁸⁸ Ibid, Arts. 255 (2), 280, 296

⁸⁹ Jesse H. Choper, Jhon C. coffee, Jr. and C. Robert Morris, Jr., *Cases and materials on corporations*, (3rd ed.), case book series, Little, Brown and Company (Canada Ltd), Canada, 1989, p. 145

⁹⁰ Supra note 6, p. 131

Second, limited liability makes it possible and sometimes attractive to shift assets out of the corporation after a creditor has extended credit to the corporation. It would be easy for share holders to distribute assets to themselves- particularly in case of one-man and family companies-while leaving the debts with their corporation in violation of creditors' right. Or more subtly, share holders or directors may undertake highly risky (volatile) investments or increase leverage in order to shift uncompensated risk on to the shoulders of creditors.⁹¹

All of these opportunistic moves, however, would lose much of their appeal if share holders did not have the shield of limited liability to protect their personal assets from the consequences of contractual default on the part of the corporation.

Therefore, the doctrine of **lifting (piercing)** the veil involves disregarding the attribute of legal personality of a corporation and reaching to the share holders and other persons involved in the management of a company who are protected by the veil. The meaning and the concept of the doctrine of piercing the corporate veil is discussed below.

2.2. THE DOCTRINE OF PIERCING THE CORPORATE VEIL

2.2.1. The Origin and notion of the doctrine of piercing the corporate veil

As discussed above, a company is regarded as a distinct legal entity with a separate existence from its membership and management team. The independent legal status of the corporate entity is said to **cast** a **veil** between the company and its human constituents- 'the corporate veil' or "the shell of incorporation". This veil serves as a partition or curtain between the company and its members and is regarded as a **privilege** for the share holders as it protects them from the risk of unlimited liability for the debts of the company.⁹²

However, such privilege of limited liability may not always exist for certain reasons including when the legal personality of a company is used for illegitimate or unlawful purposes. If it is shown that the legal personality has been abused and used to the detriment of third parties (creditors), the theory of legal personality (i.e. the separate and distinct existence of the company from that of its members) is disregarded and it is

⁹¹ Ibid, p. 132

⁹² Supra note 84, p.35

looked upon as a collection of persons instead of a collection of capital.⁹³ Consequently, the individual members will be held liable for the wrongs caused through the use of the legal entity. Hence, when this is done by courts or sometimes by statute, it is said that the corporate entity is disregarded or the veil of incorporation is pierced.

The doctrine of piercing the corporate veil has its origin in the **common law legal system** particularly in England⁹⁴. Originally, it was a reaction to a rigid stand of the House of Lords on a famous decision that is known for establishing the principle of distinct entity of the corporation. In the *Salomon V. Salomon & Co. Ltd* case (as stated above) the House of Lords decided that a corporation is different from its share holders. The House of Lords decided that:

‘The company is at law a different person altogether from the subscribers to the memorandum; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the act (law).’⁹⁵

Therefore, this decision established not only one of the most important principles of corporate personality that a corporation is a distinct entity apart from that of its shareholders but it also led to the development of another important doctrine- “**piercing the corporate veil**”. After this case, the realization that the corporate personality could be used in a fraudulent manner came into the area of the law governing corporations. Consequently, the doctrine of piercing the corporate veil began to assume a certain shape and form and recognized in different forms both in the common law and civil law legal systems.

Thus, piercing the corporate veil refers to the possibility of looking behind the company-framework (or behind the company’s separate personality) to make the members liable, as an exception to the rule that they are normally shielded by the corporate shell (i.e.

⁹³Supra note 4, p.339

⁹⁴ Supra note 35, p.60

⁹⁵ Supra note 58, p. 8

they are normally not liable to outsiders at all, and are only normally liable to pay the company what they agreed to pay by way of share purchase price).

Such terms as “**lifting the veil**”, “**breaching the wall of incorporation**”, “**dislodging the corporate veil**” or “**piercing the corporate veil**” are all legal terms of arts used to denote the same thing (i.e. the denial of the privilege of legal personality and limited liability).⁹⁶

In short, the piercing of corporate veil doctrine is an exception to the general rules of **limited liability** and **separate corporate personality**. In other words, under the doctrine, limited liability protection for shareholders and separate corporate personality may be overridden if certain conditions are met. The courts have repeatedly asserted that the doctrine is an **equitable** one and requires a weighing of the totality of the circumstances. Many states, in general sense, have promulgated a **two-prong (tier) test** to apply piercing the corporate veil doctrine requiring that:

First, there must be such a unity of interest and ownership between the corporation and its owners that their separate personalities have ceased to exist in reality. These factors include lack of substantive separation between the shareholders and the corporation, intertwining, non-observance of corporate formalities, shareholder domination, and overlap of corporate personnel and management.⁹⁷ **Second**, an adherence to separate corporate personality would create **inequitable results** (injustice). That is, an inequitable result would occur if the acts are treated as those of the corporation alone (a fairness requirement).⁹⁸

Hence, the application of piercing the veil requires the judge to discover the facts of a particular situation. That is, the determination of a veil piercing claim requires the judge to ascertain facts such as the extent of overlap in corporate personnel, non-observance of corporate formalities, and the degree of shareholder domination of the corporation, unity of interest and ownership and evaluate them in light of the doctrine’s underlying

⁹⁶ Supra note 5

⁹⁷ Backer, Larry Cata, *Comparative Corporate Law: United States, European Union, China and Japan, Cases and Materials*, Carolina Academic Press, Durham, 2002, p. 987

⁹⁸ Ibid

values of good faith and fairness.⁹⁹ Principally, whether the corporate entity should be set aside comes down to a question of **good faith** and **honesty** in the use of corporate privilege for legitimate ends.¹⁰⁰ It is asserted that veil piercing is justified when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime.¹⁰¹ These statements suggest that the corporate veil doctrine requires good faith and fair use of the corporate entity. This duty of good faith and fairness as principles of truth and respect in a corporation's dealing with its creditors are some of the substantive objectives of the legal order, or desirable goals or values.

In short, the corporate veil doctrine is non-conclusive. With its reference to desirable values and its non-conclusiveness, the corporate veil doctrine exhibits the **open-endedness** of a standard. That is, there is no single uniform standard for deciding and justifying veil piercing. The courts make a determination based on notions of fundamental fairness and justice on a case-by-case basis.

2.2.2. OBJECTIVES OF THE DOCTRINE OF PIERCING THE CORPORATE VEIL

The doctrine of piercing the corporate veil is applied with a view of attaining different objectives. However, given the variety of corporate veil cases, it is probably impossible to arrive at a single objective of piercing the veil that encapsulates all the cases.

These objectives are not mutually exclusive; the courts have expressed a desire both to compensate and to deter or to avoid unlawful enrichment within one case. Hence, there are different objectives for the application of piercing the corporate veil. Some of the principal objectives of piercing the corporate veil are:

2.2.2.1. Compensation for the Corporate Creditors (protection of creditors)

Piercing of the corporate veil doctrine performs a compensatory function to creditors. Creditors who are compensated by the doctrine of piercing the corporate veil could be either voluntary (contractual) and involuntary (tort) creditors.¹⁰²

With regard to contract or voluntary creditors, the doctrine helps to restore the full compensatory effects of the underlying contractual damages that otherwise would have

⁹⁹ Supra note 85, p. 509

¹⁰⁰ Ibid, p. 508

¹⁰¹ Ibid

¹⁰² Ibid, p.530

been curtailed by limited liability.¹⁰³ For example, a contractual creditor whose breach of contract claim is worth 1 million ETB against a corporation with 500,000 ETB assets would have been denied half of its compensation if limited liability were strictly adhered to. Operation of the limited liability rule would have confined maximum recovery to the sum of the corporation's assets. The doctrine ignores, or at least mitigates, the assumption that compensation from a corporation is intended to be subject to an **implicit cap** (ceiling) under limited liability.

The assumption is that when a contractual creditor enters into a transaction with the corporation, it **implicitly accepts** the fact that its maximum recovery is limited to the corporate assets. If such a creditor desires extra credit protection, perhaps in the form of shareholder personal guarantees or real securities, it should negotiate for it (i.e. the creditor can negotiate with the company *ex ante*).¹⁰⁴ Failure to undertake such negotiation is an **implied acceptance** of the cap (ceiling) on its maximum recovery imposed by limited liability.

The doctrine of piercing the corporate veil mitigates the above assumption due to various reasons.

First, due to the fact that when a contractual creditor transacts with a corporation, one of the implied terms in the contract is that the integrity and autonomy of the corporation will be respected and that the corporation will not be used for improper purposes (i.e. the contractual relationship requires good faith and fair use of the corporate entity). In this sense, veil piercing (which is applied at the time when the company is used for improper acts) can be viewed as judicial enforcement of the implied terms of the contract (i.e. enforcement of the breach of the implied terms of good faith and fair use of the corporate entity)¹⁰⁵. For example, veil piercing based on shareholder misappropriation of corporate assets can be understood as enforcing the implied contractual term that the shareholders will not engage in *ex post* opportunistic conduct.

Second, it is difficult and costly to negotiate contract-based protections in advance. Particularly, it is too costly to small creditors to afford. Moreover, it is difficult to delineate

¹⁰³ Ibid, p. 530

¹⁰⁴ Supra note 6, p. 132. This argument requiring prior negotiation of the contracting parties is called the bargain argument.

¹⁰⁵ Supra note 85, p. 531

(outline) the varieties of ex post shareholder opportunism and designing the appropriate protection against them.¹⁰⁶

Hence, piercing the corporate veil (by serving as a default rule) helps the parties to rely on the courts to supplement their contracts. By piercing the veil, the courts would be filling the gaps in the contract and inserting terms that the parties would have wanted to include and protect the creditor who did not have the bargaining power.

Another type of creditors which need much more protection or compensation is involuntary tort claimants. Like contract cases, in tort cases too, limited liability makes compensation from a corporation to be subject to an implicit cap under limited liability. The legislator has made a policy determination that tort damages be subject to a similar cap due to the assumption taken by the legislator that potential tort victims are expected to take out insurance, in advance, to make up for the shortfall.¹⁰⁷ Yet, the assumption may not always turn to be true as it is difficult to take insurance, in advance, for potential or even unknown risks. Moreover, unlike tort cases, in a contractual arrangement, a creditor can adjust his return so as to account for the perceived risks of lending money to the corporation (i.e. contracting ex ante for extra credit protection is possible). That means, such type of self-protection is not available to the tort claimant who is an involuntary creditor of the corporation.¹⁰⁸ Hence, these combined factors justify piercing to fully compensate tort creditors.

Even worse, some writers, like Hansmann and Kraakman, claim that the limited liability principle should totally be eliminated in tort cases arguing that:

*Limited liability gives the managers of a corporation incentive to incur too much risk, knowing that some of the costs of the corporation's activities will be externalized. With limited liability, the corporation can disregard the expected tort costs of a project and thus will invest in projects whose total social costs exceed total social benefit.*¹⁰⁹

¹⁰⁶ Supra note 6, p. 132

¹⁰⁷ Supra note 85, p 530

¹⁰⁸ Solomon, Lewis D., and others, *Corporations Law and Policy: Materials and Problems*, (3rd ed.), American case book series, West publishing Company, USA, 1994 , p.334

¹⁰⁹ Ibid

Thus, the above authors advocate replacing the limited liability with a rule that subjects shareholders to pro-rata liability for tort damages in excess of the corporation's resources. This would give managers a greater incentive to consider the full expected social cost of the corporation's torts and adjust the corporation's behavior accordingly.

Therefore, though it is not appropriate to take the extreme position to the extent of total elimination of the limited liability principle, it is fair to argue that the doctrine of piercing the corporate veil should be a guiding rule for courts in tort cases. Thus, tort creditors will be able to be compensated fully from the assets of shareholders or managers if the company's assets are not sufficient.

To sum up, the extent to which the corporate veil doctrine performs a compensatory function depends on the nature of the underlying claim and the identity of the creditor.

2.2.2.2. Prevention of Unjust Enrichment of the Shareholders

Prevention of unjust enrichment of the shareholders is the other objective of the corporate veil piercing doctrine. Unjust enrichment is the consequence that may result if separate corporate personality is strictly adhered to (i.e. it is enrichment at the expense of another). In other words, unjust enrichment is the equitable principle by which one, who has been enriched at the expense of another, whether by mistake, or otherwise, is under a duty to return what he has received or its value to the other.¹¹⁰

The logical question that follows is: how would shareholders of a corporation unjustly enrich themselves at the expense of the creditors?

The benefits received by a corporation are the proceeds of a loan or purchase money for corporate bonds. To the extent that the corporation, and by extension the shareholders, receive these benefits without making full payment for them and the default risks have not been fully compensated for, the shareholders can be said to have been enriched.¹¹¹ It is obvious how shareholders are enriched if these benefits have not been fully paid for. Shareholders' enrichment only becomes unjust if the circumstances under which it arises can be considered unjust under notions of natural justice or

¹¹⁰ Supra note 85, p. 542

¹¹¹ Ibid, p. 545

equity.¹¹² This means that mere non-satisfaction of corporate liabilities would not constitute unjust enrichment. It is only when the enrichment results under unjust circumstances, such as when the shareholders have misappropriated corporate assets, hence leaving insufficient assets to satisfy the outside creditors, that veil piercing is justified¹¹³. In this instance, the unjust enrichment equals the amount of assets misappropriated by the shareholders that would have been available to the creditors.¹¹⁴

As stated above, unjust enrichment is premised on notions of natural justice and equity. This echoes the courts' repeated assertions that the corporate veil doctrine is ultimately about preventing injustices. The characterization of unjust enrichment as an equitable principle that allows the courts to create individualized exceptions to general legal rules also suitably describes the role of the corporate veil doctrine as a standard-based exception to the general rule of limited liability. The courts have in fact used unjust enrichment of the shareholders as a basis for veil piercing in some cases.¹¹⁵ Unjust enrichment compels the recipient of an ill-gotten benefit to return it to the rightful beneficiary. Hence, the corporate veil doctrine compels the share holders, who have unjustly benefited from the protection of limited liability, to return the benefit to the creditors on grounds of fairness.

2.2.2.3. Deterrence of Future Improper Conduct

Deterrence is another possible objective of veil piercing. It is a particularly fitting objective in light of the requirement of improper conduct in the various formulations of the doctrine. The types of conduct that qualify as improper conduct that the law would like to deter include fraud, circumvention of a statutory prohibition, misappropriation of assets, misrepresentation, and other cases of wrong or injustice. There have been

¹¹² Ibid

¹¹³ It is the existence of an improper conduct for the enrichment of the share holders that justifies piercing the corporate veil which in turn differentiates it from restitution, in which case the unlawful enrichment may resulted from non-improper conducts.

¹¹⁴ Supra note 85, p. 545

¹¹⁵ It is in cases where improper conduct is manifested. In the absence of a showing of fraud or unjust enrichment, the fact that there is an unsatisfied judgment is an insufficient ground to compel the extraordinary remedy of piercing the corporate veil.

plenty of cases in which the courts combined veil piercing with punitive damages with the express purpose to achieve deterrence.¹¹⁶

The courts combined both personal liability and punitive damages to deter the defendant from engaging in similar conduct in the future. However, the need to combine shareholder liability with punitive damages to achieve deterrent effects seems to suggest that veil piercing alone does not suffice for deterrence purposes. Moreover, attributing deterrence as the principal objective of the doctrine is complicated by the general judicial consensus that the doctrine is an equitable one whose goal is to prevent injustices.¹¹⁷ However, courts implicitly and sometimes explicitly acknowledge deterrence as a goal of piercing the corporate veil.

The logical question that follows is therefore how liability imposed through veil piercing creates deterrence?

For the law to have a deterrent effect on undesirable conduct, the penalty must be greater than the benefits the defendant obtains from such conduct. Otherwise, the defendant would be always willing to take a chance with the hope that the conduct will not be detected. If the penalty is the same as the benefit from the undesirable conduct, the defendant will have nothing to lose if s/he is caught.¹¹⁸ In fact, theoretically, the penalty or damages should be set as the **benefit multiplied** by the **reciprocal** of the probability of **apprehension** (possibility of detection).¹¹⁹ For example, if the shareholder's dissipation of corporate assets has a 20% chance of detection, and the dissipated assets are worth 1 million ETB, the penalty on the defendant should be set at 5 million ETB to achieve full deterrent effect.

The question of how the corporate veil doctrine achieves deterrence needs to be analyzed differently for **intentional improper** conduct and **non-intentional**, probabilistic improper conduct such as negligence-based torts.¹²⁰ This is because as far as intentional conduct is concerned, the perpetrator has control over whether the

¹¹⁶ Supra note 85, p. 534

¹¹⁷ Ibid, p. 535

¹¹⁸ Ibid, p. 536

¹¹⁹ Ibid, p.536

¹²⁰ Ibid

conduct is undertaken. In order to deter such conduct, the law needs to impose an expected penalty on the perpetrator that is equal to the benefit multiplied by the reciprocal of the probability of apprehension (detection).¹²¹

Deterrence of **probabilistic** conduct is relatively straightforward. The main type of such conduct as far as the corporate veil doctrine is concerned is negligence-based torts committed by the corporation. In this case the tort may take place despite the precautions undertaken by the tortfeasor. Thus the law needs to ensure that the tortfeasor is liable for the full damages it causes so that it internalizes the full costs of its negligent conduct.¹²² To the extent that the underlying tort damages were already set to achieve deterrence, preservation of the deterrent effect only requires that the corporation and its shareholders fully internalize the harm caused by the tort.¹²³ In other words, the corporate veil doctrine only needs to shift unmet liabilities to the shareholders, which is precisely what the doctrine does.

However, it is argued that shareholder liability resulting from veil piercing does not achieve effective deterrence.¹²⁴ Moreover, one may argue that the corporate veil doctrine should not be concerned with shareholder misconduct if it does not result in failure to meet corporate liabilities.¹²⁵

¹²¹ Ibid,

¹²² Ibid, p. 537

¹²³ Ibid

¹²⁴ This failure to achieve effective deterrence is due to different reasons. **First**, the corporate veil doctrine does not impose penalties nor does it directly take into account the shareholder's gains from his improper conduct. The doctrine merely holds shareholders responsible for unpaid corporate liabilities. The outstanding liabilities may have little to do with the perpetrator's ill-gotten gains. If the gains exceed the outstanding liabilities, merely holding the culpable shareholder liable for the latter will not achieve effective deterrence. **Second**, and more importantly, achieving effective deterrence of intentional conduct requires the unpaid liabilities to be adjusted for the probability of detection. The case law shows that this is not done by the courts. Without such an adjustment, the corporate veil doctrine will not effectively deter intentional shareholder misconduct.(see Cheng, Thomas K., Form and substance of the doctrine of piercing the corporate veil, p.537)

¹²⁵ Supra note 85, p. 537. Some argue that, as long as the creditors are fully paid off, the doctrine of piercing should have no application. Deterrence of such conduct is the responsibility of other areas of corporation law, like the criminal law.

In short, though there are arguments against deterrence, as an objective of piercing the corporate veil, some common law courts either explicitly or implicitly cite it as one purpose of piercing in their decisions.

So far, we have been observing the general conceptions of a corporation (the theories of corporate personality and its attributes) and the origin and meaning of the doctrine of “piercing the corporate veil.” We will now turn to the survey of the doctrine both in the common law and civil law legal systems to see how and to what extent this doctrine applies.

CHAPTER THREE

3. THE DOCTRINE OF PIERCING THE CORPORATE VEIL IN THE COMMON LAW AND CIVIL LAW LEGAL SYSTEMS

3.1. The doctrine of piercing the corporate veil in the common law legal system

As stated earlier, the origin of the doctrine of piercing the corporate veil is in the common law, particularly in England. It is also said that the doctrine has been extensively used and developed for over a century in the American system. It is therefore proper to have a survey of the application of the doctrine in the common law legal system with special emphasis on English Law.

3.1.1. Grounds of piercing the corporate veil in the common law legal system

A great deal of literature has been written about the circumstances under which the corporate entity is pierced. But, unfortunately, a consistent guiding principle has not yet evolved to govern the numerous cases in which the legal entity was disregarded or pierced and it is very difficult to predict with any certainty as to when the courts will lift the veil of incorporation.¹²⁶ All literature have something in common- they say that the legal entity will not be allowed to stand if doing so would justify wrong, protect fraud or work injustice. That is, legal personality will be disregarded if doing so would promote "equity."¹²⁷ More specifically, the corporate veil will be pierced in cases when the corporate device is used to defraud creditors, to evade existing obligations, to circumvent a statute, to achieve monopoly.¹²⁸ However, there is no consistency as to the application of courts in piercing the veil.

Putting it differently, the application of the doctrine of veil piercing is far from clear in case laws. It is said that it is still impossible to discern any broad principle of company law indicating the circumstances in which a court should lift the corporate veil. Different writers describe the absence of common and universal principle for piercing the corporate veil.

¹²⁶ Susan Barber, (ed.), *Text book of Company Law*, (3rd ed.), Old Bailey Press, London, 2001, p. 12

¹²⁷ Supra note 11, p.7

¹²⁸ *ibid*

Herron CJ, described lifting the corporate veil as an “esoteric” label¹²⁹.

He further stated that:

“Authorities in which the veil of incorporation has been lifted have not been of such consistency that any principle can be adduced. The cases merely provide instances in which courts have on the facts refused to be bound by the form or fact of incorporation when justice requires the substance or reality to be investigated...”¹³⁰

Rogers AJA has described the authorities for piercing the corporate veil as “incoherent and unprincipled” stating that:

“There is no common, unifying principle, which underlies the occasional decision of the courts to pierce the corporate veil. Although an ad hoc explanation may be offered by a court which so decides, there is no principled approach to be derived from the authorities.”¹³¹

In short, the corporate veil doctrine is non-conclusive. Due to its non-conclusiveness, the corporate veil doctrine exhibits the **open-endedness** of the standard. That is, there is no single uniform standard (ground) for justifying veil piercing. The courts make a determination based on notions of fundamental fairness and justice on a case-by-case basis (i.e. courts tend to take a fact-based approach to questions of piercing the corporate veil, and no particular trend is readily apparent).

Most writers approach the subject by identifying broad headings under which judicial intervention to lift the corporate veil has occurred.¹³² Therefore, instead of merely stating the grounds of piercing the corporate veil, it is better to see some of the most important class of cases- i.e. cases which have precedence value- in which the legal entity theory has been disregarded by the common law courts. This is because the common law mainly depends on the case law or precedent. These cases will tell us some of the grounds cited by courts for piercing the corporate veil.

¹²⁹Supra note 20, p.4

¹³⁰ Ibid

¹³¹ Ibid

¹³² Supra note 126, p. 12

3.1.1.1. Piercing the Corporate Veil in case of Fraudulent Abuse (fraud exception)

Piercing the corporate veil may be justified when the formation and subsequent existence of a company constitutes a fraudulent abuse of the incorporation process.¹³³ The fraud exception considers the incorporation of a company to be a **sham** or **facade**¹³⁴. To justify this exception, a company must have been incorporated for an improper or illegitimate purpose. Ordinarily, the fraud exception will operate where the underlying motive for incorporation was to enable the company's human constituent(s) to impugn a pre-existing obligation with a third party (i.e. to evade contractual obligations). In such cases the court may recognize the existence of the corporate entity but may nevertheless pierce the corporate veil to prevent individuals involved in the illegitimate activity from escaping a liability that otherwise would have been enforceable had the individual(s) concerned not sought to hide behind the company's separate legal status.¹³⁵ Thus, the motive for which a company is incorporated is the most relevant in determining whether a corporate veil should be pierced to impose liability on the members of the company.

An example of cases in which the veil of incorporation is pierced on the ground of fraud exception was the **Gilford Motor Co. Ltd V. Horne [1933] Ch 935,¹³⁶(Court of Appeal)** in which Mr. Horne entered into a contract with Gilford Motor Co. Ltd by which he agreed to abide by a restrictive covenant which provided that should he leave Gilford's employment (as he was a managing director of Gilford Motors Co.), he would not solicit their customers. Up on leaving Gilford's employment Horne, through nominees, formed a company (JM Horne & Co. Ltd, in which his wife and an employee were sole share holders and directors) through which he impliedly sought to escape the terms of a restrictive covenant. The court held that the company was a '**sham**', an **alias**

¹³³ Supra note 58, p.14

¹³⁴ Supra note 20, p. 12. A company is said to be a Sham or façade if the corporate form is incorporated or used as a "mask" to hide the real purpose of the corporate controller. A 'sham' is something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive. As noted above, a "fraud" exception is dependent upon a "sham" argument as the courts have held that no fraud can be perpetrated where the corporate form is real and not a façade.

¹³⁵ Supra note 58, p. 15

¹³⁶ Supra note 72, p.62

of Horne, and as such an injunction was granted to enforce the covenant. The restrictive covenant was enforced against both Horne and the company, that is, the company's corporate existence was not denied although the company's corporate veil was pierced to recognize Horne's personal culpability for the breach of the restrictive covenant.¹³⁷ In effect, Horne had established a company as a fraudulent device to evade the terms of the restrictive covenant in order to escape the terms of a pre-existing contractual obligation entered into with the Gilford Motors Co. Ltd.

In the above case, the company whose separate existence was disregarded had been established deliberately in an attempt to evade an existing obligation. These types of companies are regarded as a '**sham**' or '**facade**' used to mask the real situation and justifies veil piercing.

3.1.1.2. Piercing the Corporate Veil to Establish Single Economic Entity

This ground of piercing applies if there is a unity of interest and ownership between the corporation and its owners that their separate personalities have ceased to exist in reality¹³⁸. This is when there is lack of substantive separation between the shareholders and the corporation, and overlap of corporate personnel and management. Even though more than two separate companies are established, the law will consider them as **one and single economic entities** if they are not operated as wholly separate entities, but instead combine their resources to achieve a common business purpose.¹³⁹ This ground of piercing the corporate veil grounded itself on two inter connected (inter related) theories of piercing the corporate veil: the "**alter ego**"¹⁴⁰ theory and "**single enterprise theory**"¹⁴¹ of piercing the corporate veil.

¹³⁷ Ibid

¹³⁸ This clearly indicates that the mere use of a subsidiary does not necessarily subject a parent corporation for the liabilities of a subsidiary corporation.

¹³⁹ The law in Texas regarding piercing the corporate veil, p. 6, available at: <http://www.pdfcarl.com/The-Law-in-Texas-Regarding-Piercing-the-Corporate-Veil-Section-1-....html>

¹⁴⁰ The "alter ego" theory also called "another self" theory permits a court to impose liability upon an individual shareholder, officer, director, or affiliate for the acts of a corporation. This theory may also be used to impose liability upon a parent corporation for the acts of a subsidiary corporation when the subsidiary is "organized or operated as a mere tool or business conduit." A court will look at many factors to determine whether an alter ego relationship exists. When dealing with an individual and a corporation, the court will look at the total dealings of the corporation and the individual, including evidence of the degree to which corporate and individual property have been kept separate; the amount of financial interest, ownership, and control the individual has maintained over the corporation; whether the corporation has been used for personal purposes. In these cases the court will

There are different situations by which the corporate veil is pierced based on this ground.

One of such situation is in case of **Group of companies** (parent-subsidary or brother-sister companies): In this case, the courts may pierce the veil of corporation to allow a group of companies to be regarded as one, if they are not, in reality, independent either in human or commercial terms.¹⁴² Piercing the corporate veil to establish a single economic entity removes the corporate veil of the subsidiary (subservient) company, merging that entity with the dominant entity (holding company), or merging brother-sister companies thereby constituting a single economic entity. An economic entity may be deemed responsible for the activities of both the dominant and the subservient parties¹⁴³.

To pierce the corporate veil in order to impose liability upon a parent corporation for the obligations of a subsidiary, the factors the courts should consider, though not exhaustive, include: common stock ownership between parent and subsidiary; common directors and officers between parent and subsidiary; parent's financing of the subsidiary; parent's payment of salaries and other expenses of subsidiary; parent's use of subsidiary's property as its own; whether directors and officers of subsidiary are

disregard their separate personality and consider them as a single entity working in different form or shape. (See the law in Texas regarding piercing the corporate veil. P. 1-5 cited above).

¹⁴¹ A "single enterprise" theory of piercing the corporate veil is another interconnected theory to the theory of "alter ego" which is used to impose liability when businesses integrate their resources. In order to take advantage of the corporate form of limited liability, parties will often incorporate several different business concerns under the belief that each incorporated entity will protect them from any and all personal liability of each business concern. Courts, however, apply the single business enterprise theory to pierce the corporate veil in situations where two or more corporations are not operated as wholly separate entities, but instead combine their resources to achieve a common business purpose. When courts find that a single business enterprise exists, they will hold each corporation liable for the obligations of the other relating to the common business purpose to avoid an "inequitable outcome." The courts used a "single enterprise" theory to pierce the corporate veil in order to reach the assets of a subsidiary's parent corporation or to reach the assets of any other entity involved in the single business enterprise. Courts have listed several factors that are to be considered when determining whether a single business enterprise exists. These factors, though not cumulative, include having common employees; common shareholders; common officers; centralized accounting; payment of wages by one corporation to another corporation's employees; services rendered by the employees of one corporation on behalf of another corporation; unclear allocations of profits and losses between corporations; undocumented transfers of funds between corporations etc. (see the law in Texas regarding piercing the corporate veil, pp. 6-8). Both the "alter ego" and "single enterprise" theories are inter-related as the purpose and effect of the two theories is identical: to allow a plaintiff to recover from another party when a corporation does not have adequate assets.

¹⁴² Keenan Denies, *Smith & Keenan's Company law*, (12th ed.), Pearson Longman, Book aid international, 2009 , p. 26

¹⁴³ Supra note 58, p. 16

acting independently or in the best interests of the parent.¹⁴⁴ These factors will testify that the unity of interest was more complete and the exercise of control over the subsidiary is more intimate, in a way justifying veil piercing.

An example of a case in this respect is **DHN Food Distributors V. Tower Hamlets London Borough Council [1976] 1WLR 852 (Court of Appeal)**.¹⁴⁵ In this case: DHN

Food Distributors (DHN) was a holding company which ran its business through two wholly-owned Subsidiaries, Bronze Investments Ltd. (Bronze) and DHN Food Transport Ltd. (Transport). The group collected food from the docks and distributed it to retail outlets. Bronze owned the premise in Bow from which the business was conducted and Transport ran the distribution side of the business. Tower Hamlets compulsorily acquired (i.e. through expropriation) the premises in Bow for the purpose of building houses; and as a result it leads all the three companies to go in to liquidation as it is difficult to find other suitable premise. DHN Company claimed compensation for the **value of the land**, and **disturbance of business**. Tower Hamlets was prepared to pay €360,000 for the value of the Land but refused to pay compensation for the disturbance because DHN and transport had no interest in the land.¹⁴⁶

The Court of Appeal, revising a ruling of the lands tribunal, held that the group of companies should be treated as a **single economic entity** (although the land belonged to another company, the shareholders of which were identical to those of the two others), and that in consequence compensation for disturbance should be paid. Lord Denning in his decision states that:

*"This is especially the case when a parent company owns all the shares of the subsidiaries ... These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says ... The three companies should, for present purposes, be treated as one."*¹⁴⁷

This unity of identity manifested itself in various ways. The directors of DHN were the same as the directors of bronze and Transport; the share holders of Bronze and Transport were the same as in DHN and they had a common interest in maintaining on

¹⁴⁴Supra note 139, p. 3

¹⁴⁵ Supra note 72, p.64

¹⁴⁶ Ibid

¹⁴⁷ Supra note 4, p. 349

the property of the group. Hence, these companies as a group are entitled to compensation not only for the value of the land but also compensation for disturbance. This is an instance of piercing the corporate veil for the benefit of the share holders.

The other situation by which the corporate veil is pierced on the ground of establishing an economic entity is the case of **one-man company**. One man companies face a great threat of having their legal personality disregarded. This is because there is abundant chance for mingling (mixing) of personal and company assets and to completely control (dominate) corporate policy.¹⁴⁸

A mere proof that one man owns all the stocks of a corporation cannot destroy its separate entity. Rather to make a corporation bound by acts of the stockholder and vice versa, the following circumstances must appear:

First, that the corporation is influenced and governed by the sole owner and that there is unity of interest and ownership that the individuality or separateness of the said person and corporation has ceased.¹⁴⁹

Second, that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.¹⁵⁰ That is, the facts set forth should disclose that the dealings were in form with a corporation but in reality with an individual and that a refusal to recognize this fact will bring about inequitable results.

Third, the corporation must be the corporate double (alter ego) of the sole stockholder.¹⁵¹ In other words, the stockholder must have confused (mixed) the corporate business with his other affairs, and an application of the conception of separate personality of the corporation must lead to injustice.

A well known case in this regard is **Wenban Estate V. Hewlett**¹⁵² **[June 3, 1924] 67 Cal. Dec. 493, 227 Pac. 723.** In this case, the corporation (Wenban Estate) brought

¹⁴⁸ Wormser I. Maurice, 'Piercing the veil of corporate entity', *Columbia Law Review*, Vol. 12, No. 6, Columbia law review association Inc. 1912, p. 504

¹⁴⁹ E. O. E., 'Corporations: Disregarding Corporate Entity: One Man Company', *California Law Review*, Vol. 13, No. 3, California law review Inc, 1925, p.238

¹⁵⁰ Ibid, p.239

¹⁵¹ Ibid

¹⁵² Ibid, p.236

suit to have 500 out of 1000 bonds issued by the corporation declared null and void, on the ground that they had never been delivered by the corporation. Mrs. Wenban, the sole stockholder, had made a contract with Hewlett, and delivered the bonds to him for purposes stated in the contract. Hewlett had transferred most of the bonds to purchasers for value. The court held that the acts of Mrs. Wenban bound the corporation, although not done in the corporate name, or by authority of the board of directors, and that there was therefore a valid delivery of the bonds. The grounds of the decision were that where a corporation is but the **instrumentality** through which an individual who is the sole stockholder transacts his business, the corporation will be bound by the acts of the sole stockholder just as he would be bound if the corporation did not exist. The corporation was the corporate double of Mrs. Wenban.¹⁵³

The court rightly held that the corporation is bound by acts done by the only person beneficially interested. Where the sole stockholder does not distinguish between the corporate business and his individual affairs, there is no reason for the court to make this distinction.¹⁵⁴

In general, to pierce the corporate veil either in parent-subsidary companies or in one-man company on the ground of establishing a single economic entity, the courts must consider:

*The extent to which the financial affairs and accounts of a corporation and those who control it are confused (mingled) to the prejudice of creditors; the undue diversion of its funds to individual use; the holding out of a subsidiary as a mere department, branch or part of the system.*¹⁵⁵

However, the above factors are stated in general terms and the courts are given discretion to appraise a particular situation in each case.

3.1.1.3. Piercing the Corporate Veil on the ground of Agency

Where the company is acting as an agent of the shareholders, then the latter will be held liable for its acts. There may be an express agreement¹⁵⁶ to this effect or such

¹⁵³ Ibid, p. 237

¹⁵⁴ Ibid

¹⁵⁵ Supra note 11, p.13

¹⁵⁶ Gulshan, S.S and Kapoor, G.K., *Company law: Including MRTTP Act, FERA and Interpretation of Statutes*, Wiley Eastern Limited, New Delhi, 1991, p. 5

agreement may be implied from the facts of a particular case though there is no express agency agreement¹⁵⁷. In other words, the concept of agency has sometimes been used by the courts under which the subsidiary is regarded as an agent¹⁵⁸ of its holding company (sole owner in case of one-man company), even though there is no agency agreement as such between them in regard to the transaction concerned. The effect is that the transactions entered into by a subsidiary are regarded as those of the holding company (sole owner in case of one-man company) for which the holding company (sole owner in case of one-man company) is liable.

As stated earlier, an agency relationship equates to a façade in respect of establishing an economic entity. However, although an agency relationship may establish the existence of an economic entity, it must be noted that in terms of pure theory, an agency relationship creates **no disturbance** to the subsidiary's corporate veil because to establish an agency relationship one must have a principal and an agent, that is two distinct legal entities.¹⁵⁹ Therefore, as a legal concept, agency is not a device which **pierce** a corporate veil, albeit, notwithstanding the theory, the finding of agency relationship between two distinct entities will result in the same effect as if the corporate veil had been lifted, namely the principal (the holding company or a sole owner in case of one-man company) will be liable for the actions of its agent (the subsidiary company).¹⁶⁰ It seems, therefore, that agency relationships are established by the Courts with the sole aim of finding the principal responsible for the acts of his 'agent'. The basis for their judgment is that the principal has manipulated his agent to act according to his specific instructions, thus depriving 'the agent' of any willpower of its own.¹⁶¹ This technique of imposing an agency relationship is used by the courts when

¹⁵⁷ Supra note 142, p. 27

¹⁵⁸ In the context of an agency relationship between corporate entities, agency may be tentatively defined as a relationship which is based upon the express or implied consent of both the subsidiary company and its holding company (sole owner in case of one-man company), whereby the subsidiary company is made subject to the holding company's control and will and to the extent that the subsidiary conducts its business affairs for the ultimate benefit of the holding company (sole owner). Therefore, to establish agency in group relationship, it is crucial to prove that one dominant company (sole owner) exerts absolute control over the affairs or acts of the other company. (see also Griffen Stephen, company law: fundamental principles, p.21)

¹⁵⁹ Supra note 58, p.21

¹⁶⁰ Ibid

¹⁶¹ Supra note 4, p.346

they are reluctant to ignore the veil completely, which is considered real lifting the veil, but achieve the same result as that of piercing the veil.

This ground of piercing the corporate veil is mainly implemented for purposes of liability to tax.¹⁶² Putting it differently, if the purpose for which a company is established is for tax-evasion or circumvention of tax obligation, the court may not recognize the separate legal existence of the company.

An example of a case in this regard is **Firestone Tyre & Rubber Co. Ltd V. Lewellin [1957] 1 All ER561**¹⁶³. In which case an American company formed a wholly-owned subsidiary in England to manufacture and sell its brand of tyres in Europe. The American company negotiated agreements with European distributors under which the latter would place orders with the American company which the English subsidiary would carry out. In fact the distributors sent their orders to the subsidiary directly and the orders were met without any consultation with the American company. The subsidiary received the money for the tyres sold to the distributors and, after deducting its manufacturing expenses and plus 5 percent, it forwarded the balance of the money to the American company. All the directors of the subsidiary reside in England (except one who was the president of the American company) and they managed the subsidiary's affairs free from day to day control by American company.¹⁶⁴

The House of Lords held that the American company was carrying on business in England through its English subsidiary acting as its agent and it was consequently liable to pay United Kingdom tax.¹⁶⁵

From the foregoing discussion, it is clear that the common law courts have used such **elastic** and **flexible** terms as “equity, fraud, single economic entity, agency or instrumentality” as grounds to pierce the corporate veil and to reach to those persons who have used the corporate device for various improper purposes and to grant justice (remedy) for those wronged.

¹⁶² Supra note 156, p. 4

¹⁶³ Supra note 142, p. 27

¹⁶⁴ Ibid

¹⁶⁵ Ibid

3.2. PIERCING THE CORPORATE VEIL IN THE CIVIL LAW LEGAL SYSTEM

Although the doctrine of piercing the corporate veil has its origin in the common law legal system, it has also influenced the civil law legal system at large.

Hence, the survey of piercing the corporate veil in the civil law legal system, particularly French law, to see how they respond to the doctrine is found to be important. This is because, our country, at least in principle, belongs to the civil law legal system and the French law has been the direct source of our Commercial Code of 1960.

The French law recognizes two types of companies with separate legal existence and limited liability of the members. These are **Limited Liability Company**¹⁶⁶ and **Public Limited Company**.¹⁶⁷ As can be seen from the provisions of the French Commercial Code, the Limited Liability Company is similar to that of the Private Limited Company of Ethiopia, except that in French law limited liability company may be established by one man and some other procedural differences, whereas the Public Limited Company is similar to the Ethiopian Share company subject to some procedural variations as can be seen from the definition.

However, the separate legal entity and limited liability of the French companies may be disregarded and shareholders and persons participated in the management of the company may be held liable for certain grounds.

3.2.1. Grounds of Piercing the Corporate Veil in French Legal System

Unlike the common law legal system, there are few grounds by which the corporate veil is pierced under the French law. These grounds could either be Statutory and judicial piercing.

¹⁶⁶ The French Commercial Code: Commercial Companies and Economic interest Groups, updated 03/20/2006, compiled by Zekarias Keneaa, Art. L 223-1. A limited liability company may be formed by one or more persons who shall be liable only in respect of their contributions and designated by the name, in which may be incorporated the names of one or more members and which must be immediately preceded or followed by the words "Societe A Responsabilite Limitee" or the initials "SARL". Insurance, investment and savings companies may not adopt the Limited Liability Company form.

¹⁶⁷ Ibid, Art. L225-1. A public limited company is a company whose capital is divided into shares and which is formed among members who shall bear any losses only up to the amount of their contributions. It is also called Societe Anonyme (SA).

3.2.1.1. Statutory Piercing of the Corporate Veil

In France, piercing the corporate veil is mainly the task of the legislature (i.e. the legislature provides some statutory solution to the problem of piercing the corporate veil) though the courts are not totally devoid of such power. The French law provides some provisions by which the corporate veil may be pierced.

One of such circumstances is piercing the veil in case of **bankruptcy**. The French law makes the members or peoples who have acted as managers and any person who used the company's property as his own and benefited thereafter liable for the debts of the company when its assets become insufficient to pay off creditors.¹⁶⁸

The reason for making the managers liable for the debts of a company is due to the presumption of the law that in such a situation the managers have failed to be diligent and careful in managing the affairs of the company. Hence, the liability may be discharged by proof that the manager and the other administrators concerned have performed the obligations incumbent upon them in respect of the affairs of the company completely and with due diligence.¹⁶⁹ However, absence of actual participation in management or supervision of the company, after assuming such a position, cannot be a defense to escape from liability. In one case the court of appeal of **Douai (in France)** held that the president of a company's board of management was liable to pay one-half of the company's debts.¹⁷⁰ This gentleman raised as a defense that he had taken no part whatever in the actual management of the company's affairs, leaving the latter entirely to a deputy director appointed by him.¹⁷¹ Such lack of supervision and interest on his part not only provided no excuse, but on the contrary furnished a good reason for declaring him personally liable because in his position as director of the company, in which he accepted both remuneration and responsibility, it was his legal duty to take an active interest in the company's affairs and not to delegate the performance of his

¹⁶⁸ Lutter Marcus, 'Limited Liability Companies and Private Companies', Vagts D.,(ed.), *International Encyclopedia of Comparative Law*, Vol.XIII, Martinus Nijhoff Publishers, 1973, p.102

¹⁶⁹ Supra note 5, p. 206

¹⁷⁰ Ibid, p. 208

¹⁷¹ Ibid

obligations to another person.¹⁷² Hence, bankruptcy is the most important and frequent situation in which the French law pierced the corporate veil. However, as discussed below, there are other situations by which the corporate veil is pierced either by the statute or by courts.

The other situation of statutory piercing the corporate veil is with respect to the **controlling share holder (s)**. The French law also attempts to pierce the corporate veil and make the controlling share holder (s) liable for the debts of the company. This controlling share holder could be a holding company or an individual shareholder. However, the mere fact that a person is the controlling shareholder of a company does not render him as such liable for the debts of the company. Where the controlling shareholder has acted properly within the limits of his legal rights, no such liability comes into existence. This is particularly true in cases in which the minority shareholders had been able to exercise their own rights of opposition and supervision.¹⁷³

However, piercing may be applied in cases in which a parent or holding company has failed to apply in its dealings the necessary distinction between its own assets and those of its subsidiary.¹⁷⁴ It was consequently applied in a case in which a subsidiary had been established with capital from the holding company, whose board habitually issued instructions to the board of the subsidiary on the management of the latter's affairs. In these circumstances the dependence of the subsidiary on the parent company was furthermore underlined by the fact that the parent company used the subsidiary for the purpose of fraudulent transactions, including the concealment of assets owned by the parent company.¹⁷⁵

This statutory piercing is similar to the common law piercing on the ground of establishing a single economic entity. This fact is affirmed by the statutory provision of a French Commercial Code stating that “*any capital held, even where this is less*

¹⁷² Ibid, p. 209

¹⁷³ Ibid, p. 207

¹⁷⁴ Ibid, 207

¹⁷⁵ Ibid, 297

than 10%, by a controlled (subsidiary) company shall be regarded as being indirectly held by the company controlling the latter.”¹⁷⁶

Similarly, the controlling individual shareholder will be liable if he had not managed the company as if it was a separate entity, but treated it as a personal enterprise of his own.

*Thus it has been held that a person who either directly or through a nominee owned the majority of the shares of a company was personally responsible for the debts of the company if he acted arbitrarily as **maitre de l'affaire** and treated the company's assets as if they were his own. Such a state was assumed to exist in a case in which, in fact, the participation of the other shareholders was found to be of no practical or economic importance, or where actual accounts were in fact not issued or where the board of management or the assembly of shareholders existed merely on paper and were in fact not convened or in cases in which the company effected sales without issuing and dispatching to its customers proper invoices, thus enabling the controlling shareholder to appropriate the cash resulting from the payment of the purchase price by the customer.¹⁷⁷*

These are some of the situations by which the French legislator has provided statutory solutions to the problem of disregarding the corporate entity.

3.2.1.2. Judicial Piercing of the Corporate Veil

Although the statutory provisions were mainly applied, French courts have in fairly few instances found it necessary to lift the corporate veil. One of the cases in which the corporate veil has been lifted by French Courts concerns cases in which valid agreements in restraint of trade had been concluded. An obligation validly entered, by which one party bound itself not to establish a competitive business in a defined area, cannot be evaded by the formation of a company which is intended to run a business in the interest of the promisor.¹⁷⁸ This is similar to the case of **Gilford Motors Co. Ltd V. Horne**, stated above, in which Horne, through nominees, formed a company (JM Horne & Co. Ltd) through which he impliedly sought to escape the terms of a restrictive covenant.

¹⁷⁶ Supra note 166, Art. L233-4

¹⁷⁷ Supra note 5, p. 206

¹⁷⁸ Ibid, p. 210

The other case by which the French courts pierce the corporate veil is in case of **defacto companies** (companies existing in fact without fulfilling the requirements of the law). This is particularly when a company fails to maintain the minimum membership requirements of a company. If the company members are reduced below the legal minimum, the remaining members of a company who are aware of the reduction of membership below the legal minimum will be jointly and severally liable for the debts of a company incurred six months after such reduction happens. This ground of piercing is relevant and applied by the courts for public limited companies and not for limited liability companies, as limited liability companies can be operated even by one man.¹⁷⁹ However, in case of public limited companies the number of members may not be less than seven.¹⁸⁰ Hence, if the number of members goes below seven, the remaining members cognizant of the fact of such reduction will be jointly and severally liable for all the debts of a company incurred six months from the date of such reduction. Moreover, they cannot invoke the nullity of the company against third parties, but third parties may use the nullity against the shareholders, managers or directors. In case of bankruptcy, they may be directly declared bankrupt without first going in to the bankruptcy of the company as there is no company at law to be declared bankrupt and proceeded against.¹⁸¹

As shown above, the French legislator and courts have played their role in piercing the corporate veil when the legal entity is employed for improper ends though statutory provisions have taken a lead in providing in advance for the piercing of the corporate veil.

Generally, the problem of piercing the corporate veil is recognized both by the common law and the civil law legal systems though at varying degree. Each legal system also tried to respond to the problem in different ways as discussed thoroughly in this chapter. We will now turn to the analysis of the application of piercing the corporate veil (i.e. both its legal significance and practical application of the doctrine by courts) in Ethiopia.

¹⁷⁹ Supra note 166, Art. L 223-1

¹⁸⁰ Ibid, Art. L 225-1

¹⁸¹ Supra note 11, p.19

CHAPTER FOUR

4. THE LEGAL SIGNIFICANCE AND PRACTICAL APPLICATION OF PIERCING THE CORPORATE VEIL IN ETHIOPIA

4.1. AN OVERVIEW OF COMPANIES IN ETHIOPIA

The Ethiopian Commercial Code recognizes two types of companies: **Private Limited Company**¹⁸² and **Share Company**. Share Companies can be formed in two ways.¹⁸³

All types of companies, after fulfilling the legal requirements and upon publication¹⁸⁴, will acquire legal personality and the attribute of limited liability of shareholders (members).

The Commercial Code vests **legal personality**, which is the most important attribute, on all types of business organizations except a joint venture.¹⁸⁵

Due to its separate legal personality, a company is a subject of rights and obligations, in its own right, distinct and separate from its shareholders, directors and managers. It may therefore, enter in to contracts not only with the world outside itself but also with its members, sue and be sued, has the right to possess property and capital by selling its

¹⁸² Supra note 1, Art. 510. A private limited company is a company consisting from two to fifty members who are liable only to the extent of their contribution. It is always commercial in form and governed by the Commercial Code provisions of Arts. 510- 543 and the general provisions applicable to all forms of business organizations (Arts. 210- 226).

¹⁸³ One way of formation of Share Company is formation as between founders without offering the shares for public subscription (Art. 316 of the Commercial Code of Ethiopia). These types of Companies are sometimes called closely held or Family Share Companies. In this case, the memorandum of association shall indicate the fact that all the shares have been allocated, one quarter of the value of the shares have been deposited in a bank and the valuation of contribution made in kind, if any, has been made in accordance with the law and the administrative organs of a company are established. The other way of formation of Share Companies is by offering shares for public subscription through a prospectus signed by all the founders (Arts. 317, 318 of the Commercial Code). The prospectus shall be made in such a way that it would help the offerors (subscribers) know the price of shares, time of payment, summary of the memorandum and articles of association. In this connection, Arts. 318-322 will apply which is not the case in closely held share companies. However, except some provisions related to its formation, both types of share companies are subject to the same provisions of the Commercial Code (Arts. 304- 509 and the general provisions applicable for all business organizations (Arts. 210-226)).

¹⁸⁴ Supra note 1, Art. 223. Under Ethiopian law there are different modalities of publicity including publicity by a notice published in a news paper empowered to publish legal notice (a news paper circulating at the place where the head-office is situate); by the deposit of two copies of the documents (i.e. two copies of the memorandum and all complementary documents) with the official in charge of the commercial register; and by registration in the commercial register.

¹⁸⁵ Ibid, Art. 210 (2)

shares, the power to compromise bona fide disputes etc.¹⁸⁶ However, since a human will is necessary to exercise those rights and respond to the duties, a company acquires rights, incurs liabilities and act in legal proceedings only through its agents.¹⁸⁷

The other attribute of Ethiopian companies, like others, is **limited liability** of the shareholders (members). The benefit of limited liability of shareholders (members) shifts some of the costs of innovation and its failures to creditors. Though it is a cost to creditors, it has different advantages including the ones stated below:

*It is maintained that people would be reluctant to invest in large and very risky endeavors without the protection afforded by the concept of limited liability. As a result, much human progress would be considerably slowed. It is further argued that conferring the benefit of limited liability on share holders is compatible with generally accepted views of fairness as a wide spread distributions of shares results in divorce of ownership from the opportunity to effectively participate in management (separation of ownership and control). Yet another benefit of this rule is that it minimizes the impairment of capital markets. The idea is that in the absence of limited liability, creditors would pursue wealthier share holders first, and the practical imposition of liability would be influenced by the relative wealth of share holders. As a result, an investment decision would involve a judgment on the financial conditions of not only the company itself but also of fellow share holders. This would entail substantial cost of acquiring information about the enterprise and fellow share holders. The bottom line: raising capital would be less efficient and organized securities markets would be impaired.*¹⁸⁸

Recognizing all these and other benefits of limited liability, the Ethiopian Commercial Code provides for the limited liability of shareholders.

Arts. 304 and 510 (1) of the Commercial Code are vital in providing the limited liability of the shareholders and members of Share Companies and private limited companies respectively.

¹⁸⁶ Seyoum Yohanness, 'On the formation of share companies in Ethiopia', *Journal of Ethiopian Laws*, Vol. 22, No.1, 2008, p.104

¹⁸⁷ Supra note 1, Art. 216

¹⁸⁸ Supra note 186, p.105

These provisions read as follows:

Art. 304- Definition of Share Company

- (1) *A share company is a company whose capital is fixed in advance and divided into shares and whose **liabilities are met only by the assets of the company.***
- (2) *The members shall be **liable only to the extent of their share holding.***

Art. 510- Definition, Nature [of private limited company]

- (1) *A private limited company is a company whose **members are liable only to the extent of their contributions.***

The above provisions vividly indicate the concept of limited liability in which members of a company are liable only to the extent of their contribution for the debts of the company. Putting it differently, the liabilities of a share company are met from its own **assets**. Assets are the sum total of what a company owns in general.¹⁸⁹ They include what the company collected from the shareholders by selling shares and earned surplus. The total initial contribution from members (i.e. the sum total of the par value of all shares issued) constitutes the **capital** of a company, as stated in the definition. The amount contributed by shareholders in excess of the par value (face or nominal value) of the share is known as **issue premium**¹⁹⁰ and is not part of the capital but is still part of the **assets** of a company.¹⁹¹

The other components of the **assets** of a company, particularly a share company, are the various types of **reserves** created from the profits generated by the company itself.

¹⁸⁹ Ibid, p.106

¹⁹⁰ Supra note 1, Art. 326. Shares can be classified as share at discount and shares at premium based on the price at which shares are issued. Shares at discount are shares issued at a price lower than its par (face) value. However, under Ethiopian law share at discount are totally prohibited. On the other hand, premium shares are shares issued at a price greater than the par value where such issue is provided by the memorandum or article of association or decided by an extraordinary general meeting. The difference between the par value and the price at which the shares are issued shall be known as a premium.

¹⁹¹ Supra note 186, p.106

Reserves may take different forms depending on the source that created them. These are:

1. **Legal reserve fund:** it is a reserve in which the law has imposed a duty to deposit five percent (5%) of the net profit annually prior to distribution in the form of dividend. The deposit of 5% shall continue till the legal reserve amounts to 20% of the total capital of a company.¹⁹²
2. **Supplementary reserve:** it is a reserve in which the articles of association demanded for deposit of such additional reserves and to be effected by an ordinary general meeting.¹⁹³
3. **Optional reserve:** it is a reserve in which the articles of association may provide for such deposit. Unlike supplementary reserve, optional reserve is not mandatory.¹⁹⁴
4. **Free reserves:** it is a reserve required neither by the law nor by the article of association but the ordinary general meeting may pass a resolution to deposit a certain amount.¹⁹⁵

Therefore, all the above constitute the **assets** of the company against which creditors may proceed for the satisfaction of their claims and no share holder is personally liable so long as s/he has made her/his promised contribution.

The logical questions that follow are, therefore, is the legal personality of companies always respected under Ethiopian laws? Can shareholder (s), director (s) or manager (s) of a company do anything they wish under the cover of limited liability and separate legal personality of the company? Is there no ground (room) for the legislator or the judges to look behind the wall of incorporation and make the human constituents liable?

As highlighted in the preceding chapters, the separate legal personality of the company and the benefit of limited liability may be employed for improper deeds. Since the law considers a company as a separate entity and protects its members by its shell of

¹⁹² Ibid, Art. 453(2(a)) cum. Art. 454

¹⁹³ Ibid, Art. 453 (2(b))

¹⁹⁴ Ibid, Art. 453 (2(c))

¹⁹⁵ Ibid, Art. 453 (2(d))

limited liability, the physical persons constituting a company may use such attributes as a mask behind which they hide themselves to further their commercial interests and avoid direct responsibility.

Therefore, the current chapter is devoted to the critical analysis of the application of the doctrine of piercing the corporate veil in Ethiopian laws and the practical application of the doctrine by Ethiopian courts with a view to answer the above questions.

4.2. The legal significance of piercing the corporate veil in Ethiopia

In Ethiopia, like in France, piercing the corporate veil is mainly the task of the legislator (i.e. the law provides for the possibility of piercing the veil and the courts put it into effect) though the courts are not totally devoid of such power. That is, the Ethiopian legislator has made holes, based on different grounds, in the corporate veil through which creditors of a company could get at those persons who are really responsible for the prejudice caused. Hence, the legal significance refers to the role of the legislator, by providing the statutory provisions, in piercing the corporate veil. This section, therefore, is devoted to the assessment of some of the possible statutory grounds of piercing the corporate veil in Ethiopia. These statutory grounds of piercing the corporate veil are discussed below.

4.1.1. Piercing the corporate veil in case of Bankruptcy

One of the most serious attempts to safeguard the interest of corporate creditors is provided by the statutory obligations placed upon certain persons in respect of their potential personal liability for the debts and liabilities of the company, following the company's slide into a state of bankruptcy. Under Ethiopian law, Arts. 531 and 1160 (1) of the Commercial Code are the two most important legal provisions in this regard.

With respect to Private Limited Companies, Art. 531 of the Commercial Code make persons that participated in the management of the company liable for the debts of the company if it becomes bankrupt.

The provisions read as follows:

Art. 531- Bankruptcy of the company

- (1) Where in a **bankruptcy** the assets are shown to be inadequate, the court may, on the application of the trustee in bankruptcy, order that the company's debts or part of them shall be paid by the **managers** or by the **members** or by **both** or some of them, with or without joint liability.*
- (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 managers and members show that they have acted with due care and diligence.*

The above provision vividly shows that if a private limited company becomes bankrupt and as a result the assets are shown to be inadequate, the court may order the managers or members or both to pay the whole or part of the company's debts separately or jointly. The terms "managers" and "members" under sub-art. (1) refer to non-member managers and member managers or members who act as a manager though not a manager in proper sense respectively. This can be understood from the words of sub-art. (2) of the same provision which stipulates that the liability shall not apply to members who have not acted as managers (non-manager members).

Therefore, the application of Art. 531 of the Commercial Code is restricted only to persons (be they members or non-members) who are managers or who acted as managers of a company thereby amplifying the principle of "**hands-off management**". Thus, it is not possible to make all members of the PLC **per se** liable during the event of its bankruptcy.

In short, as per Art. 531 of the Commercial Code, piercing applies and manager (s) will be held liable when the company is declared **bankrupt** and the **assets** are shown to be **inadequate** to meet its debts. The logical question that may follow is, as to whether piercing can apply when the assets of a private limited company are shown to be inadequate though it is not declared bankrupt? One may logically argue that piercing can also apply in this case by analogizing the provisions of Art. 366 of the Commercial

Code which makes the director (s) liable though the share company is not declared bankrupt.

In other words, the word “bankruptcy” in Art. 531 may not necessarily imply the declaration of bankruptcy but also insolvency as the legislator seems to have had in mind the falling short of assets of the company to meet its own debts.

Generally, if the company becomes unable to meet its debt, the law takes a presumption that the manager(s) were not diligent or careful in their management. However, the presumption is rebuttable and hence such persons can escape from liability by proving that they have acted with due care and diligence.

Similarly, Art. 1160 (1) of the Commercial Code, which applies for both share and private limited companies, makes certain persons liable for the debts of the company if it becomes bankrupt. The provisions read as follows:

Art. 1160- Adjudication of bankruptcy in common

*(1) 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 though they were his own and concealed his activities under the cover of such company.*

Therefore, if a share company or private limited company is declared bankrupt¹⁹⁶, creditors can require the bankruptcy of any person. Though the Ethiopian law has extended such liability to ‘any person’ subject to the fulfillment of the conditions stipulated by the law, it does not give any hint as to who these persons are. As to which persons are to be declared bankrupt, in such situations, the OHADA legal system provides for personal bankruptcy of natural persons who are managers or representatives of body corporate whether they are de jure, de facto, remunerated or not, apparent or hidden.¹⁹⁷ The Ethiopian law, though there is no clear provision indicating

¹⁹⁶ Ibid, Art. 968. A company is said to be bankrupt, it must have suspended payments and declared bankrupt by the court of law as factual bankruptcy cannot be taken as a ground.

¹⁹⁷ The Organization for the Harmonization of Business Law in Africa (OHADA), *Uniform Act Organizing Collective Proceedings for Wiping off Debts*, Art. 194

who these persons are, seems to extend the bankruptcy to any person (irrespective of whether they are managers, directors or not). Although as a matter of rule, bankruptcy applies only for traders and commercial business organizations¹⁹⁸ under Ethiopian law, Art. 1160 (1) seems an exception to this general rule. Hence, the Phrase “any person” in Art. 1160 (1) of the Commercial Code refers to “any person” (both natural and juristic), irrespective of whether they are managers, directors or not, regardless of whether they are traders or not.

Therefore, creditors can require the bankruptcy of any of such persons if a share or private limited company is declared bankrupt upon proof of the following three cumulative elements. These are:

First, the person must have carried out commercial activities on his own behalf. “On his own behalf” means that he carried on the business in his personal interest or benefit, or he must have some pecuniary or non-pecuniary interests directly or indirectly accruing to him.¹⁹⁹ Though a director or a manager, while carrying out commercial operation, has a duty to act in the interest of the company in which it is a director or manager, it may not always be the case as the director or manager may run the affairs of the company to fulfill its own interest.

Second, the person must have disposed of company funds as though they were his own. This means that a person must treat the assets of the company as his own assets, or used the corporate assets or credit to his own interest at the expense of the company. Though it is not clear as to what does the phrase “company’s funds” under Art. 1160 (1) refers to, it is logical to understand that it should not be limited to imply the company’s liquid money but rather it includes all properties constituting the company’s assets.

Third, the person must have concealed his activities under the cover of such company. This means that a person must use the company as a mask to achieve his own purposes at the expense of the latter. In other words, he must conceal his activities

¹⁹⁸ Supra note 1, Art. 968 cum. 1155

¹⁹⁹ Supra note 11, p.24

employing the company as a shield and transact using the companies name but for his own personal profit.²⁰⁰

Therefore, Art. 1160 (1) of the Commercial Code, upon the burden of proving the above cumulative elements, extends the company's bankruptcy to any person, regardless of whether they are managers, directors of a company.

One thing to be noted at this point is that, creditors of a bankrupt private limited company have a dual option to exercise their claim. **Firstly**, they can base their claim on Art. 531 of the Commercial Code and proceed against managers or persons that participated in the management of the company without a need to extend bankruptcy proceeding of the company to the manager. This is because the creditors would not have the burden of proving that the manager(s) were not diligent or careful in their administration of the company since the law makes a presumption of non-diligence. Moreover, 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 claim.

Secondly, if it is not possible to recover the debts from managers according to Art. 531, they may require the court to extend the bankruptcy to such persons as per Art. 1160 (1) of the Commercial Code upon the burden of proving the conditions required by law.

Generally, the legislator has provided the above statutory provisions to pierce the corporate veil in bankruptcy cases under Ethiopian Law.

4.1.2. Piercing the Corporate Veil in case of Failure to discharge duties diligently

Director (s) are responsible for exercising the duties imposed on them by law, the memorandum and articles of association or resolution of the meetings of shareholders, with the care due from an agent.²⁰¹ Accordingly, director (s) will be held liable to the company's creditors where they fail to **preserve intact** the company's assets and consequently, it become **insufficient** to meet its liabilities.

²⁰⁰ Ibid, p.25. This fact can also be analogized from the provision of Art. 290 (1) of the Commercial Code.

²⁰¹ Supra note 1, Art. 364 (1)

In the common law legal system, this ground of statutory piercing the corporate veil is called “misfeasance proceeding”.²⁰² In which case, persons who were involved in the management of a company may be held accountable for any breach of duty or other act of misfeasance.

As per **Art. 366** of the Commercial Code, the liability of director (s) is a fault-based liability- i.e. if they fail to preserve intact the assets of the company which in turn leads to the insufficiency of its assets to meet its debts. Where the company’s assets are insufficient to satisfy the claims of the creditors, the latter may proceed against the director (s) for the payment of their unsatisfied claims. When the company’s assets are shown to be insufficient, the directors are presumed as having failed to keep and preserve the company’s assets intact. The only way out for the directors is to show that they have acted with due care and diligence. They would not be liable to third parties if they could show to the satisfaction of the court that they have carried out their duty diligently and carefully.²⁰³ The presumption of the law for failure of directors to carry out their duty, in case where the assets of the company becomes insufficient to satisfy the claims of creditors, shifts the burden of proving to the directors themselves. Moreover, the resolution of the general meeting not to institute proceedings against the directors would not excuse the delinquent director (s) from the incursion of any personal liability as a consequence of a wrongful act.²⁰⁴

Contrary to the argument of Seifu Tekle Mariam, who restricted the application of Art. **366** of the Commercial Code only when the company is declared bankrupt, the writer of this paper argues that the proper application of Art. **366** would rather be before the company is declared bankrupt. If the application of Art.**366** is only in bankruptcy cases of a company, it would be a mere redundancy and serve no purpose as the liabilities of directors in case of bankruptcy are already addressed by Art. **1160 (1)** of the commercial code, as discussed above.

²⁰² Supra note 58, p.335. The term “misfeasance” is a generic term used to describe conduct which results in any breach of duty, conflict of interest or breach of trust, where the consequences of the wrongful act results in an improper application of the company’s assets or property.

²⁰³ Supra note 1, Art. 364 (5)

²⁰⁴ Ibid, Art. 366 (3)

For a company to be bankrupt, two cumulative conditions should be satisfied. These are **suspension of payment**²⁰⁵ and **declaration of bankruptcy**.²⁰⁶ Factual bankruptcy does not make a company bankrupt. In other words, where no judgment in bankruptcy is given, bankruptcy shall not result from mere suspension of payments.²⁰⁷

The requirements to make director(s) liable, according to Art. **366** of the Commercial Code, are their failure to preserve intact the company's assets and as a consequence of this failure the company's assets become insufficient to meet its liabilities. Only one of the conditions for bankruptcy- i.e. suspension of payment and not judgment of bankruptcy- is required to make director (s) liable for the debts of a company under this legal provision. Therefore, this clearly amplifies the fact that Art. **366** of the Commercial Code shall apply to make director (s) liable for the debts of a company without requiring the company to be declared bankrupt. Putting it differently, factual bankruptcy suffices to make director (s) liable under this legal provision. But, it does not mean that this provision will not apply in case of bankruptcy; it may apply for stronger reasons.

Another ground of piercing the corporate veil due to mismanagement of the company is the distribution of **fictitious dividends**.²⁰⁸ The reason why the writer considers this ground of piercing the corporate veil as the "mismanagement of the company" or "failure to discharge duties diligently" is due to the fact that such act (distribution of fictitious dividends) is mostly the result of decisions made at the managerial level.

²⁰⁵ Ibid, Art. 971. Suspension of payment may result from any fact, act or document showing that the debtor is no longer able to meet the commitments related to his commercial activities.

²⁰⁶ Ibid, Art. 969

²⁰⁷ Ibid, Art. 970 (1)

²⁰⁸ Normally, dividends may only be paid to share holders from net profit shown to in the approved balance sheet (See Art. 458 (1) of the Commercial Code). The net profit for distribution comprises the net receipts for the financial year after deduction of general costs and other charges, amortization and allowances, previous year losses and reserves of different types (See Art. 452 of the Commercial Code). Thus, dividends distributed from the accounts of a company other than the net profits shall be treated as **fictitious dividends** and the persons making the distribution shall be civilly liable.

Though making fictitious dividends alone may not automatically become a ground for piercing the corporate veil, it would be if the persons make fictitious dividends with the aim of under capitalizing²⁰⁹ the company and thereby to deny the creditors' claim.

One writer clearly stated that under capitalization of a company is a clear ground of piercing the corporate veil stating:

*"If a corporation is organized and carries out business without substantial capital in a such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that the shareholders in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risk of loss, this is a ground for denying the separate entity privilege."*²¹⁰

Under Ethiopian law, the effect of making fictitious dividends can be seen in two ways. First if the company is non-family company and second if the company is family company.

If fictitious dividends are made in case of non-family companies, they may not be claimed back from the shareholder receiving it.²¹¹ Hence, the question that follows is what will be the fate of third party creditors if the assets of the company are insufficient to meet their claims? The law in unambiguous manner states that the persons making the fictitious dividend shall be civilly liable,²¹² which means that

²⁰⁹ One thing to be noted in this connection, however, is the fact that making fictitious dividends may not necessarily lead to undercapitalization. Moreover, it may be difficult to prove the fact that a person makes fictitious dividends with the intention of under capitalizing the company. Hence, the burden of proving that fact lies on the creditors and the court should consider different factors to decide whether a person making fictitious dividends has the intention of undercapitalizing the company or not.

²¹⁰ Buxbaum, Richard M., 'The formation of marketable share companies', Conard A. (ed.) *International Encyclopedia of Comparative Law*, Paul Siebeck, 1975, p.37

²¹¹ Supra note 1, Art. 459

²¹² Ibid, Art. 458 (2)

creditors can claim from the personal assets of the persons making the fictitious dividend. This is therefore, a clear ground of piercing the corporate veil.

The effect of making fictitious dividends in case of **family companies**, where the shareholders of a company are usually directors and officers, are small in number, relatives and friends and that they fail to keep corporate property separate from their personal property,²¹³ is a little bit different. In such type of companies, the fictitious dividends may be claimed back from the share holders in addition to making persons distributing fictitious dividends civilly liable.²¹⁴ Since the fictitious dividends are claimed back from shareholders and the capital of the company is restored to its previous position, it would not be fair to allow third party creditors to claim from the persons making it. Moreover, making the shareholders return the dividend received may not be considered piercing the corporate veil. Further, though, a person making the fictitious dividend is still civilly liable to the shareholders and is responsible to compensate the shareholders for the damage and inconveniences they sustained as a result of his mismanagement, it is difficult to consider it as a case of piercing.

Hence, if fictitious dividends are paid with the aim of **undercapitalizing** the company and thereby to deny the creditors' claim in case of non-family companies, the law allows the creditors to make persons making such distribution –mostly manager (s) or director (s) - civilly liable for their failure to manage the company diligently. This is, therefore, a clear instance of piercing the corporate veil.

Similarly, in case of private limited companies, the manager(s) are not liable to third parties for any act they perform in accordance with the law and the article of association of the company they lead. The shield of legal personality of the company protects managers, too, from personal liability. However, the law pierces such veil in favor of third parties where the managers breach their duty provided by law and the article of association.²¹⁵

²¹³ Brown, Gordon W. and Sukys, Paul A., *Business Law: with UCC Applications*, (11th ed.), McGraw-Hill Companies, Inc., New York, 2006, p. 708

²¹⁴ Supra note 1, Art. 459 cum 458 (2)

²¹⁵ Ibid, Art. 530

Therefore, these are some of the statutory holes to make director (s) and manager (s) liable for the debts (liabilities) of the company on the ground of “failure to discharge duties diligently” under Ethiopian law.

4.1.3. Piercing the Corporate Veil during reduction of members below the legal minimum

A share company shall not have less than five members and always commercial in form irrespective of its objects.²¹⁶ However, failure to maintain this minimum required number of members may lead to the dissolution of the company and liability of members for the debts of a company. In this regard, Art. **311** of the Commercial Code is vital. As per this provision, “no company shall remain in business for more than six months after the number of members is reduced to less than five.” The creditors or even the members may make an application, to the court, to order the winding-up of a company if the members are less than five or the company does not possess the prescribed organs. In addition, creditors may make the remaining members, who are aware of such reduction, liable for their claims. This is clearly provided under Art. 311 of the commercial code which states that: “... every member aware of such reduction [of members] shall be personally liable for the debts contracted thereafter.”

Therefore, creditors can make the remaining members, who are cognizant of such reduction, liable for the debts of a company incurred after six months from the reduction of members occurs. In other words, the liability of the remaining members is not related to the debts incurred before the happening of the reduction of the members and the debts incurred within six months from the reduction of the members. The six month period is regarded as a “**grace**” period during which the remaining members of a company may avoid personal liability by either reorganizing the company or by filing a petition for the winding-up of a company. This provision is based on the assumption that the danger of abuse of the principle of separate legal personality tends to be greater where the company is controlled by a few or, worse, by a single person.²¹⁷

²¹⁶ Ibid, Art. 10(2)

²¹⁷ Supra note 168, p.103

This is therefore, a clear ground of piercing the corporate veil under Ethiopian law which, in fact, is similar to the French legal system.

Similarly, a private limited company shall not have less than two and more than fifty members and is always commercial in form.²¹⁸ If the number of members goes below two or, where the organs of the company cease to exist, the court may order the dissolution of the company upon the application of the creditors or a member after giving reasonable time for the company to make arrangements to comply with the law.²¹⁹ The only remedy available to creditors is requiring the dissolution of a company. Unlike share companies where creditors can make the remaining members personally liable, there is no such similar provision regarding private limited companies. Since the purpose of both provisions seems similar- i.e. protection of creditors' interest-there is no valid reason for the legislator not to give similar protection for creditors of private limited companies by allowing them to extend their hands to the remaining member.

4.1.4. Piercing the Corporate Veil in case of Defective Formation

Defective formation is a formation of a company without fulfilling the legal requirements for its formation. All corporate laws set forth certain requirements for the commencement of legal existence of companies. Where a corporation has substantially complied with all conditions precedent to incorporation, the corporation will have **dejure** (right and lawful) existence and no one would challenge its personality. On the other hand, where any one of these requirements is not fulfilled, the question arises as to the consequence of such failure and whether the corporation can exist despite such defects.

Different legal systems made distinction between two categories of defects in the formation of a company. These are defects pertaining to the “**agreement to form a corporation**” and “**formal or technical defects**.”²²⁰

As stated in the second chapter of this paper, the initial act of incorporation of a company is a contract.²²¹ Hence, the validity requirements for the formation of a contract

²¹⁸ Supra note 1, Art. 510 (2)

²¹⁹ Ibid, Art. 511

²²⁰ Supra note 186, p. 123

are applicable for the formation of a share company. So, defects related to the validity requirements of a contract comprise the first category of defects. The second types of defects consist improper publication of the memorandum, defects of form thereof, failure to hold organizational meetings and the like, which are more formal and technical in nature.²²²

Each type of defect has different consequences. Though there is no uniformity in the different legal systems, defects related to an “agreement to form a corporation” would result in the **retrospective nullity** of a corporation (i.e. the formation of a corporation is void ab initio where its legal existence is not recognized). Whereas, “technical” or “formal” defects results in dissolution and winding-up of a company and not the nullity of a company (i.e. the legal existence of a company is not affected).²²³

Under Ethiopian law, no valid contract may exist unless parties capable of contracting have given their consent sustainable at law; the object of the contract is sufficiently defined, is possible, moral and lawful; and made in the prescribed form required by the law.²²⁴ Hence, under Ethiopian law, defects related to these could be regarded as defects relating to “agreement to form a corporation”. On the other hand, defects in the requirements like minimum number of share holders, minimum initial capital, full subscription of capital, payment of 1/4th of the par value of cash shares, adoption of the memorandum and articles of association, registration and publicity, fall under the “formal” or “technical” defects.

Regarding defective formation and its effects, Art. 324 of the Commercial Code is indispensable and states as follows:

Art. 324-Effect of Publicity

*(1) Where publication and registration have been made, the company shall have a **legal existence** and **personality** notwithstanding that all the legal*

²²¹ The fact that a corporation is a result of a contract is also stipulated under Art. 211 of the Commercial Code.

²²² Supra note 186, p. 123

²²³ Ibid, p. 124

²²⁴ Supra note 1, Art. 1 of the Commercial Code Cum. Art. 1678 of the Civil Code.

requirements relating to the formation of the company have not been complied with.

*(2) Where the **interest** of creditors or shareholders are **endangered** by the legal or statutory requirements not having been complied with, the court may, on the application of any such creditor or shareholder order the **dissolution** of a company and such provisional measures as may be necessary .*

(3) An application not made within three months from the date of publication in the official commercial Gazette shall not be considered.

The above provision does not classify defects in formation in to defects related to “agreement to form a company” and “formal” or “technical” defects. It simply says defects in formation will have no consequence on the legal existence or personality of a company once it is registered and publicized. Hence, under Ethiopian law, both forms of defects have same effect- dissolution of a company and not nullity.

In short, under Ethiopian law, a company will have a legal personality, though defectively formed, so long as it is properly registered and published. However, if such defective formation is detrimental to the interests of creditors or shareholders, the court may order the dissolution of a company upon the application of the former. Unlike other country’s laws like France, where defective formation is a ground for piercing the corporate veil, the Ethiopian law does not provide a clear provision to that effect. The only remedy provided by Code is dissolution of the company.

4.1.5. Piercing the Corporate Veil in case of Group Companies

“Corporate groups” is a general term for a class of corporations, which are also known as related companies. The term corporate groups signifies companies related as between themselves through the ownership of shares, organization of management or through indirect mechanisms that entail control or influence of one company by the other.²²⁵ These related companies may be classified in to two based on their structures as well as on the basis of their relationships. These are:

²²⁵ Supra note 35, p.31

1. Vertically related companies or parent-subsidary companies

These are companies related because one company holds shares in the other company or exerts substantial control on the management of the company. Companies are vertically related when there is a single or more companies having control over one or more companies through ownership of the majority of the equity shares and as a result holding majority votes, having the power to constitute and alter the management of the company or by indirect means affect and control the direction of the company.²²⁶ This being the general understanding, different jurisdictions define holding (parent) and subsidiary companies differently and there is no uniformity as to the meaning. However, Black's Law dictionary defines holding company as "a company owning more than 50% of the voting shares, or otherwise a controlling interest of another called the subsidiary." Similarly, it defines subsidiary corporation as "subsidiary corporation is one in which another corporation, called parent corporation, owns at least a majority of its shares."

2. Horizontally related companies or brother-sister companies

Horizontally related companies, also called 'affiliated companies', 'sibling companies' or 'brother-sister companies' exist when there are two or more companies, which have common share holders who are natural persons and who own the whole of these companies as between themselves.²²⁷ These types of companies are created by owners who wish to attain a certain business goal by using multiple corporations that function as a single enterprise.

The usual way of formation of brother-sister companies is through the splitting of a company, in to various companies which carry out the usual business of the company. Brother-sister companies are also formed when a company becomes successful and the share holders decide to enter in to related business ventures by incorporating new business entity or corporation distinct from the original company.²²⁸

²²⁶ Ibid, p.35

²²⁷ Ibid, p. 36

²²⁸ Ibid, p.51

The difference between the vertically related and horizontally related companies is that the natural persons are behind each company in case of horizontally related companies. While in the case of vertically related companies, the one which is behind the subsidiary is the parent company- i.e. liability is attached only to the assets of the parent company without affecting personal assets of individual members of the parent company, since the group structure awards these individual members with a double layered shield. Hence, in order to find the physical persons behind the parent corporation, one would have to pass at least the corporate veil of two companies (the veil of the subsidiary and the parent company).

These related companies may be formed for different abusive purposes. For instance in case of brother-sister companies, share holders may split a company in to various distinct business entities with the hope of minimizing the assets that will be available to the creditors of a company.²²⁹ Similarly, shareholders may enter in to new related business by incorporating new business entity so as to minimize the possibility of risks of the new venture to the other company.²³⁰ The logical question is therefore, is there any possibility to make the sister-brother companies liable if one of them become unable to pay their debts? The Ethiopian law does not provide clear provision as a ground for piercing the corporate veil of the brother-sister companies.

In case of parent-subsidiary Company, the parent company, by using its controlling power, may misconduct and endanger the various interests. For example, minority share holders may have little control and as a result they are unable to prove the fraud committed by the parent company due to high cost of litigation and unequal bargaining power with the parent company.²³¹ Similarly, the creditors of the subsidiary may be highly affected due to the reduction in the solvency of the subsidiaries which could be caused by the parent company's misconduct.²³² Some of the abusive conducts which prejudice the minority share holders and creditors of the subsidiary include: the

²²⁹ Ibid

²³⁰ Ibid

²³¹ Ibid, p. 52

²³² Belayneh Ketsela, *The need for the regulation of Groups of companies (parent-Subsidiary companies) in Ethiopia*, Senior Thesis, Faculty of Law, Addis Ababa University, 2006, p.32

dominated subsidiary situation;²³³ **integrated economic enterprise situation;**²³⁴ **inadequate financial structure;**²³⁵ **misleading of third parties** etc.²³⁶

Hence, the misconducts of the parent company which affects creditors is committed under the guise of the principle of separate personality and limited liability- i.e. although the parent company is a member of the subsidiary, both are distinct entities at law and liabilities of the parent company are limited to its own capital investment- which serve as a shield against the subsidiaries creditors who are prohibited from pursuing their claims from the parent company whenever the subsidiary fails to meet its liabilities.

Therefore, to protect the interests of the subsidiary company's creditors, different country's company laws recognize the doctrine of piercing the corporate veil, either by the statute or by the courts based on the ground of establishing single economic entity theory or on the ground of agency, to entitle the subsidiary's creditors to proceed against the parent company. Of course, some countries, in addition to piercing the corporate veil rule, also provide **special regime** for regulating group companies to protect creditors by giving the subsidiary's creditors the right to proceed against the parent company without the need to prove any abusive acts of the parent company.²³⁷

²³³ This is a situation in which the subsidiary company acts not for its own interest, but to its detriment for the benefit of the group as a whole or for the benefit of some group members only. This happens due to excessive intervention and domination by the parent company in the affairs of the subsidiary. (See Belayneh Ketsela, pp. 34)

²³⁴ This is a mechanism by which a single economic enterprise is incorporated in to several legal units for certain economic purpose. These groups of enterprises have a centralized management, and subsidiaries are generally controlled from the headquarters.

²³⁵ This is a situation when a parent company under capitalizes the subsidiary company and as a result creditors of the subsidiary would be seriously affected by the likely diminished or totally impoverished financial capacity of this subsidiary resulting from such undercapitalization. (See Belayneh Ketsela, p.40)

²³⁶ This is a situation when a number of groups of companies usually use a common public group persona, and the various group members are publicized as a single enterprise. This could be done by using various mechanisms such as the use of common group name, common trade mark, integrated advertisement campaign etc. This will misled third parties as they may transact with one subsidiary in the belief that they are transacting with the group as a whole or with the parent company. Moreover, due to the high intimacy with the group of companies, which can be witnessed from the above activities, even a creditor that knows the separate personality of the subsidiary company could believe as if the subsidiary he is contracting with is financially supported by the parent company or the group as a whole, in case the subsidiary fails to meet its debts. (See Belayneh Ketsela, p.41-42)

²³⁷ Supra note 232, p.5.

In Ethiopia, though the Commercial Code recognizes the idea of group companies²³⁸, there is no precise definition for parent and subsidiary company. The absence of precise definition in determining the degree of control that a company exercises over another company to be regarded as a parent, may unfairly prejudice the interest of the subsidiary's creditors.

Some statutory attempts are made under our commercial law to pierce the corporate veil of the parent company so as to make it liable for its abusive acts. As per the 1960 Commercial Code, a **subsidiary company** can proceed against a parent company that acts as its **director**, pursuant to the right given to bodies corporate to act as directors of a company.²³⁹ Similarly, **creditors** of a subsidiary can also proceed against the parent company acting as a director of their debtor (i.e. the subsidiary) if it fails to perform its duties imposed by law, the memorandum or resolution of meetings which consequently leads to the insufficiency of the assets of the subsidiary²⁴⁰ or during **bankruptcy** of the subsidiary as per Art. 1160 of the Commercial Code, as discussed above. In such situations, the separate legal personality and limited liability of the parent company may be disregarded and it may be held liable beyond the contribution it has made in the subsidiary.

However, these remedies are available only against a director parent company (i.e. only when a parent company is chosen as a director of the subsidiary company as per Art. 347 (4) of the Commercial Code). Therefore, there are no other extensive statutory grounds of piercing in case of corporate groups so as to make the parent company

²³⁸ One of the areas of the Commercial Code recognizing group of companies is provided under Art. 344 of the Commercial Code. This is restrictions on cross holding- i.e. in holding and subsidiary companies where the holding company has control over the subsidiary through ownership of the majority of the voting stock of the subsidiary company, the subsidiary company cannot hold shares in the parent or the holding company exceeding 10% of the total number of shares. The purpose is to prevent fraudulent avoidance of minimum capital requirements and any possible harm to the creditor. The other areas where the parent-subsidiary companies are recognized include in its requirement of registering the shares of the director of the company in its subsidiary or in other company to which it is subsidiary (Art. 360 (1)); in its prohibition of auditors from becoming a manger or a director of the parent or subsidiary of the company which they audit (Art. 370); in its call for extension of investigation to the affairs of holding and subsidiary company (Art. 384); in its requirement for submission of the accounts of the subsidiaries at the general meeting of the shareholders of the company if the latter is a holding company (Art. 451) etc.

²³⁹ Supra note 1, Art. 347 (4), 364 (1), cum. 366

²⁴⁰ Ibid, Art. 366 (1)

liable for the debts of the subsidiary in the event when the parent company is not appointed as a director of the subsidiary under Ethiopian law.

4.1.6. Piercing the Corporate Veil in Case of Trade Restraint

The other ground which may call for the application of the doctrine of piercing the corporate veil in Ethiopia is when a person uses the corporate device to evade his obligations, be it legal or contractual. That is, if the underlying motive for incorporation of a company is to enable the company's human constituent(s) to avoid their pre-existing obligation with a third party, it will give a room for piercing the corporate veil. We can find some provisions in the Commercial Code imposing restrictive obligations on individuals.

Art. 158 (1) of the Commercial Code provides that the seller of business shall refrain from doing any act of competition likely to injure the buyer for a period of five years following the date of sale of the business. In particular, he may not carry on, in the vicinity of the business he sold, a trade similar to a trade carried on by the buyer. Thus, if a seller of a business establishes a closely held company or other company in which he holds a majority of shares and engaged in a competitive business which is likely to injure the buyer in the vicinity of the business he sold, the court should consider the established company as a device to evade his restrictive legal obligations.

The same applies in case of evasion of contractual obligations. An obligation validly entered in to, by which one party binds him/herself not to establish a competitive business in a defined area, cannot be evaded by the formation of a company which is intended to run a business in the interest of the promisor.

Art. 30 (2) of the Commercial Code provides that a commercial employee and a trader may provide, in their contract of employment, a restrictive clause prohibiting the commercial employee from carrying on private trade (i.e. from entering in to competitive business with his employer or engage in any way what so ever in undertaking which would compete with the employer) upon the expiry of a contract of employment.²⁴¹

²⁴¹ The contractual restriction imposed upon the employee is valid if and only if the work given to the employee enables him to meet the clients of the employer or enter in to the secrets of his business. (Art. 2589 of the Civil Code). In other words, the restrictive agreement is valid if it is necessary for the protection of the legitimate interests of the employer. Plus, the restrictive agreement should not impede, in an inequitable manner, the economic future of the employee. To this end, the restrictive agreement should be limited as to time, place and

Thus, if a commercial employee establishes a closely held company or other company in which he holds a majority of shares and engaged in a competitive business with his former employer, the court should consider the established company as a device to evade his restrictive contractual obligations.

Therefore, a person should not be allowed to evade his obligations, legal or contractual, by forming a company in which he holds a great majority of the shares or establishing a closely held share company. If he establishes a company in contravention to the restrictive obligation imposed upon him by law or by agreement, the court may recognize the existence of the corporate entity but may nevertheless pierce the corporate veil to prevent him from escaping a liability that otherwise would have been enforceable had the individual concerned not sought to hide behind the company's separate legal status.

In short, these types of companies should be regarded as a '**sham**' or '**facade**' used to evade obligations and justifies veil piercing.

So far, we have been analyzing the grounds of piercing the corporate veil under Ethiopian laws (i.e. statutory piercing). Now we will turn our discussion to the treatment of the doctrine in Ethiopian courts so as to understand the practical application of the doctrine.

4.2. The Practical Application of the Doctrine of Piercing the Corporate Veil by Ethiopian Courts

So far we have been discussing about the possible statutory grounds of piercing the corporate veil. This is a section that we devote on assessing whether the Ethiopian courts apply the doctrine of piercing the corporate veil and if so, how they apply it.

Selamu Bekele, in his thesis, argued that Ethiopian courts/tribunals cannot pierce the corporate veil saying: "in Ethiopia the law which has given legal personality to

business forbidden to the employee. (Art. 2590 of the Civil Code of Ethiopia). Moreover, the employer may not avail himself of such restrictive provision where he has cancelled the contract of employment or refuse to renew it without good cause or if it is proved that the employer has no material interest in its maintenance. (Art. 2592 of the Civil Code of Ethiopia).

commercial companies has itself made enough holes in the veil of the legal personality so that more piercing seems unworthy of effort.”²⁴² He further argued that:

*According to the Ethiopian, which in effect is French, approach the law itself has raised the mask to a certain extent, raising beyond which appears to be contrary to a policy of a codified legal system whose aim is to ascertain the law in a code form and give little opportunity for the exercise of a judges’ discretion. The wall of legal personality in Ethiopian law is built in such a manner that it is neither too strong nor too weak. If a judge wants to dig a hole through such a wall he may safely do so in regard as to what breach of duties by a director or manager of a company means. Even there, the law has set a legal standard. Finding whether a director has breached his duty, by not having due care or diligence or by not keeping the company’s assets intact, is a matter of fact. As such it could not have been defined any narrower as a legal principle. But that is far from letting the judge have complete discretion to collapse the wall from its foundation.*²⁴³

Selamu Bekele concluded that a judge need not peep through or beyond the wall to look at the persons who may hide behind it to the prejudice of creditors. In Selamu’s opinion, the role of the judge is only to look through the openings built by the legislator and this can be achieved only by ascertaining whether a director has breached his duty, by not having due care or diligence or by not keeping the company’s assets intact. In effect, Selamu argued that the only statutory ground of piercing is failure of a director to act diligently and to keep the company’s assets intact.

However, in this paper, the writer argued against the view of Selamu that Ethiopian courts should have and have in fact certain discretions to pierce the corporate veil for reasons other than the statutory grounds of piercing provided by the legislator. Though Ethiopia does not belong to the common law legal system, its company law is influenced both by the common law and civil law legal systems.

²⁴²Selamu Bekele, *Private commercial companies under Ethiopian law: their legal and practical significance*, Senior Thesis, Faculty of Law, Haile Selassie I University, 1966, p. 22

²⁴³ Ibid, pp. 22

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 without 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...*²⁴⁴

Therefore, the Ethiopian company law is influenced both by the common and civil law legal system though we call Ethiopian belongs to the civil law legal system in general terms.

Moreover, even when we say that Ethiopia belongs to the civil law legal system, it does not mean that the judges are limited and bound solely by the legal provisions of the Codes. One of my interviewee stated that the judges have discretion to be inquisitive and flexible in the interest of justice and this reality is clear if we look at the role of judges in the court proceedings as provided in the Civil Procedure Code.²⁴⁵ Another interviewee²⁴⁶ also stated that the door is not completely closed for the exercise of judicial piercing in Ethiopia at least through a broad interpretation of the available statutory holes.

To strengthen this argument, the writer analyzes some real cases in which the courts and /or administrative tribunals pierced the corporate veil even when there is no clear statutory provision.

The first case that involved the doctrine of piercing the corporate veil in Ethiopia appeared few years after the enactment of the Commercial Code. This was **Mosvold (Ethiopia) Ltd. V. The Inland Revenue Department.** The case was first seen by the Tax Appeal Commission, as Mosvold (Ethiopia) Ltd. V. The Inland Revenue

²⁴⁴ Winiship P. (Editor and Translator), *Background Document of Ethiopian Commercial Code of 1960*, Faculty of Law, Haile Selassie I University, Artistic Printers, Addis Ababa, 1972, P. 61

²⁴⁵ Interview with Ato Asrat Eshetu, Assistant judge at the Federal High Court, on may 17, 2011

²⁴⁶ Interview with W/ro. Hirut Melesse, former Federal supreme court Judge, on may 25/2011

Department, File No. 1130/56, on appeal against the income tax assessment by the Inland Revenue Department which treated the appellant company and a related company (Mosvold Wood Works Ltd.) as single entity for income tax purposes.²⁴⁷ The argument of the appellant was that the two companies (i.e. Mosvold (Ethiopia) Ltd. and Mosvold Wood Works Ltd.) are separate and distinct legal entities validly formed by separate memorandum of Association and registered in the commercial register; that they have different business purposes since one is engaged in commercial activities while the other is engaged in manufacturing (industry); that there is no law enabling the revenue department to consider the two entities as if one is the main office and the other a branch and that they are separately registered in the Ministry of commerce and Industry. Hence, the appellant argued that, the Inland Revenue Department erred in considering them as a single entity for income tax purposes.²⁴⁸

The counsel for the Inland Revenue Department, on his part, replied that the two companies are registered separately for tax avoidance purposes; that their activities are related and Mosvold (Ethiopia) Ltd. gets all the benefits, and Mosvold wood works is owned exclusively by Mosvoled (Ethiopia) Ltd. and its share holders. Hence, he argued that their income must not be treated separately and the consolidation of the book of accounts of the two entities is proper.²⁴⁹

The Tax Appeal Commission, after hearing the arguments of both parties, held that the two companies should be treated as single entity for tax purposes. The tribunal reasoned that, even if the two companies were registered separately, the shareholders in the first company are exclusively the founders of the second company; that the two companies undertake sale transactions jointly and also share the profits, and it appears that the second company was formed in order to reduce the income tax liability of the enterprises as a whole. Therefore, the Commission, by majority vote, decided that the incomes of the two companies shall have to be consolidated for purposes of levying the

²⁴⁷ In principle, every member of a group companies is with its distinct personality which is followed by limited liability. Thus, in tax laws, each member of a group bears its own tax burdens on the basis of all the profits it has earned, irrespective of the loss and profits the other group may have incurred.

²⁴⁸ Mosvold (Ethiopia) Ltd. V. The Inland Revenue Department (Tax appeal Commission, 1965), J.Eth.L., Vol. 4, No. 1, p. 122

²⁴⁹ Ibid

income tax notwithstanding the fact that they are organized as separate companies under the Commercial Code.²⁵⁰

The above decision of the Tax Appeal Commission, though not raised by the Commission, can also be supported by the provisions of Art. 451 of the Commercial Code. Art. 451 (1) of the Commercial Code states that where a company is a holding company, the accounts of its subsidiaries shall be submitted to the annual general meeting at the same time and in the same manner as its own accounts.²⁵¹ That is, a consolidated balance sheet and profit and loss account shall be prepared in respect of the holding company and its subsidiaries.²⁵² The only exceptions to this rule are where the directors are of opinion that the drawing up of such balance sheet would be impractical or too onerous, or of little concern to the shareholders on account of the small financial interests involved,²⁵³ or where the directors of a 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 shareholders carry out business of such a differing nature that they may not reasonably be deemed to form a single enterprise, and if this opinion is approved by the Ministry of Commerce and Industry.²⁵⁴ As the facts of the case shows, the two related companies are engaged in activities of similar or related nature.

This decision of the Tax Appeal Commission shows that Ethiopian courts (Administrative Tribunals) played a role in applying the doctrine of piercing the corporate veil. That is, if companies are established with a view of evading or minimizing tax, courts and tribunals may consider such group as a single entity for tax purpose²⁵⁵, as an exception to the rule.

²⁵⁰ Ibid, p. 123

²⁵¹ Supra note 1, Art. 451 (1)

²⁵² Ibid, Art. 451 (2)

²⁵³ Ibid, Art. 451(3)

²⁵⁴ Ibid, Art. 451(4)

²⁵⁵ Some commentators argue that treating a group as a single entity is more advantageous for that group in case of tax. They argue that if a group is considered as a single entity, the losses that the other group members have incurred will be deducted from the profits of one group member whenever taxable profits are calculated which ultimately reduces the taxable income. Moreover, it has also the advantage of avoiding tax

The above case was also appealed to the High Court, seen as Mosvold (Ethiopia) Ltd. V. The Inland Revenue Department, file No.820/58,²⁵⁶ against the Tax Appeal Commission's holding that the appellant company and the related company should be treated as a single entity for income tax purposes.

Unfortunately, the High Court reversed the decision of the Tax Appeal Commission arguing that companies organized separately under the Commercial Code are to be treated as separate entities for tax purposes. It further argued that the intention of the legislator is not to hold such companies as one legal entity for tax purposes. If the contrary was the intention of the legislator, it would have as well provided for such cases in the tax law itself.²⁵⁷

The High Court simply decided that the two companies, registered separately in the commercial register, are two distinct bodies and entities without further inquiring other circumstances to see whether Mosvold Wood Works was, in fact, a subsidiary and established for tax avoidance or other improper purposes. In particular, the share holding in the two companies must be considered. The shareholders in Mosvold Wood Works were four. Out of the 300 shares 294 of them were held by the appellant, Mosvold Company. The remaining six shares were equally held by three persons who were also shareholders in the appellant company.²⁵⁸ The court should have also considered how the business of the Mosvold Wood works was being conducted. That is, the fact that both companies undertake related activities in which the appellant was engaged in furniture selling business and that the second company provided it with the necessary woodwork products. Hence, the decision of the court reversing the decision

charges on gains from intra-group transactions. For example, if one group member acquires certain assets from another group member, the gains of the seller company do not trigger a tax charge as the transaction is considered to be undertaken with in a single entity. (See Belayneh Ketsela, the need for the regulation of group Companies in Ethiopia, pp.21-22 cited above). However, the above argument will have merit only when the group of company is unfortunate. But, if the groups of companies are profitable, the sum of profits will be higher thereby increasing the tax liability.

²⁵⁶ Mosvold (Ethiopia) Ltd. V. The Inland Revenue Department (High court, 1967), J.Eth.L., Vol. 4, No. 1, p. 104

²⁵⁷ Ibid, p.105

²⁵⁸ Supra note 11, p.28

of the Tax Appeal Commission seems improper and non-considerate of the realities behind the companies.

The other recent case involving the doctrine of piercing the corporate veil is between **W/rt. Feven Zemen and Others V. Askalukan Trading PLC and Others, file No.96230**.²⁵⁹

The plaintiffs are 42 persons,²⁶⁰ while the defendants are Askalukan Trading PLC, Ato Girmaye G/Michael (A director for a PLC), W/ro. Mena Terefe (A manager for a PLC), and Ato Girma Bekele (An accountant for a PLC).

The facts of the case in short are as follows. Askalukan Trading PLC made announcements through different Medias (News Papers, Radio, TV, Notices etc.) that it is the only organization to arrange a travel to South Africa to attend the 2010 World Cup events organized in South Africa. Hence, the plaintiffs concluded a contract with the Askalukan Trading PLC in which it undertook to arrange travel to South Africa to enable them attend the 2010 World Cup events. To this end, the PLC collected 37,582.65 birr from each of the 40 plaintiffs, birr 47,632.06 from one of the plaintiffs which price included her child, and birr 48,333.67 from the other one of the plaintiffs which price included her child, and a total amount of 1,599,217.06 birr from the 42 plaintiffs. However, the company was unable to discharge its duties and even refuses to repay their money to the plaintiffs.²⁶¹

Even though summons was sent to the defendants to appear on the date fixed for the hearing, they were not able to appear except the fourth defendant (Ato Girma Bekele). The court then, ruled to hear the case in their absence (ex parte).

The fourth defendant, at the hearing, argued that he is a mere employee (an accountant) of the company who did not involve in the affairs of management. He further argued that he should not be responsible because the company has its own

²⁵⁹ W/rt. Feven Zemen and Others V. Askaluka Trading PLC and Others, (Federal High court, Civil File No. 96230, 2003 E.C), Unpublished. The Decision of the court is annexed to this paper.

²⁶⁰ It is in this file No. 96230 that the plaintiffs are only 42. The defendants are sued by other number of persons in many separate files. It is because the decision of the court is so brief that the writer chooses file NO. 96230.

²⁶¹ The statement of claim of the plaintiffs prepared and submitted to the federal high court in sene 28/2002 E.C annexed to this paper.

legal personality and since the contract was concluded between the plaintiffs and the company itself.²⁶²

After hearing his oral argument, and the evidences presented to it, the court dismissed the fourth defendant (Ato Girma Bekele) freely on the ground that he is a mere employee of the PLC; that he had no contractual relationship with the plaintiffs; that he is neither a member nor a director or manager of the PLC.²⁶³

However, the court decided that the company (Askalukan PLC), the director (Ato Girmay G/Michael), and the manager (W/ro. Mena Terefe) are jointly and severally liable for the claims of the plaintiffs together with legal interest rate (i.e. 9% per annum).²⁶⁴ That is, the plaintiffs can satisfy their claims from the PLC, or from the personal assets of the director or the manager, or in any combination of them as the principle of joint and several liabilities allows them to do so.

As a rule, the company had its own separate legal personality and limited liability as it was lawfully established. However, the High Court, in rendering the above decision, stated that the director and manager did such illegal or fraudulent activities on the assumption (belief) that they will not be responsible for any act of the company as it has its own separate legal personality and that they were shielded by the advantage of limited liability.²⁶⁵ However, the court reasoned that, the limited liability advantage will exist if and only if the member (s), director, and manager use the company for lawful purposes. It then stressed that there is no reason why the liability of the company cannot be extended (shifted) to the director and manager if they employ it for fraudulent or illegal purposes.²⁶⁶

The other important point to be taken into account in the case at hand is the fact that the PLC was formed by two persons, who are spouses of each other; who are exclusive share holders and are at the same time director and manager of the company. Hence, there is high chance (possibility) for the personal assets of the members and the assets

²⁶² Supra note 259, the decision part, p. 3

²⁶³ Ibid, p. 6

²⁶⁴ Ibid

²⁶⁵ Ibid, p. 5

²⁶⁶ Ibid, p. 5

of the company to be intermingled and it would be easy to shift the assets of the company for their own personal benefits.

Therefore, the Federal High Court rightly pierced the corporate veil of the PLC (Askalukan trading PLC) and decided the members, who were the director and manager of the company as well, jointly and severally liable with the PLC for the claims of the creditors.

Though two of the defendants (the director and the manager) did not present any kind of argument as the case was heard *ex parte*, the decision of the court is very brief and states that the limited liability advantage will no more exist if the members, director (s) and manager (s) use the company for fraudulent purpose, in which case the company is regarded as a device or legal façade.

The above cases, though cannot fully show the jurisprudence and the stand of courts or tribunals completely, attests that the role of Ethiopian courts is not merely ascertaining the law in the Code form but also have a discretion to be flexible and apply the doctrine of piercing whenever justice or public policy require; and where rights of innocent parties are prejudiced; whenever one in control of a corporation uses that control, or uses corporate assets to further his or her own personal interests.

CHAPTER FIVE

5. CONCLUSION AND RECOMMENDATION

5.1. CONCLUSION

Different jurists and writers defined a corporation differently based on their own understanding and view. As a result, it is not possible to have a single definition which is universally acceptable to all legal systems. The presence of various definitions of corporations is the result of the existence of the different theories of legal personality, including but not limited to, the fiction theory of legal personality, the contract theory of legal personality, the realist (organism) theory of legal personality and the concession theory of legal personality, which try to explain the nature of the legal personality of a corporation. Each of these theories has a varying degree of influence on the modern concept of a corporation and legal systems of countries. For example, the approach of the Ethiopian law towards the nature of the corporation could be best explained as a **blend** of the fiction theory and the contract theory as can be seen from the readings of Arts. 210 and 211 of the Commercial Code.

A corporation, once it acquired its legal personality, enjoys certain attributes which differentiates it from other forms of unincorporated business organizations like partnerships and joint ventures. Among the attributes of a corporation, the separate legal personality and limited liability make it the chosen mode of business form.

The attribute of separate legal personality amplifies the fact that the law considers a company as a person when it complies with all the requirements for its formation. That is, in the eyes of the law, it is a person capable of enjoying rights and assuming obligations quite different from the physical or juristic persons who brought it into existence or who may be its members at any given time. The rights and obligations of the individual members are not those of the company and vice versa. It is the House of Lords' decision in the case of *Salomon V. Salomon & Co. Ltd* [1897], in revising the decisions of the Higher Court and the Court of Appeal, marked for the beginning of the judicial acceptance of the company as a separate legal entity.

Under Ethiopian law, legal personality is acquired by fulfilling the various requirements of the Commercial Code of Ethiopia and upon publication in an official Commercial

Gazette. Once a company acquires legal personality, some important consequences attached to it. These consequences include: the company has its own name, nationality and place of residence; it can possess and administer property; it can enter into juridical acts in its own name, sue and be sued, has perpetual existence.

The other attribute of a company is limited liability of shareholders due to which the company will alone be liable for the debts it incurs. That is, if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying the company's debts out of their own private funds. The shareholders are liable only to the extent of the amount they have paid, or have promised to pay, for their shares. Putting it differently, the company's creditors cannot seek satisfaction from the members even if the company's funds (assets) are insufficient to pay its liabilities in full. Under Ethiopian law, limited liability is recognized and shareholders are liable only to the extent of their share holdings as per Arts. 304 and 510 of the Commercial Code.

This attribute of a corporation has greatly facilitated the expansion of business, particularly in the risky ventures, as it encourages greater boldness and risk-taking among the business community, so that new avenues to increasing commerce may be explored which in turn provides employment and adds to the nation's economic and financial growth, stability and prosperity.

Due to the protection it offers to shareholders, the attribute of limited liability of a corporation is known as **the veil or shell of incorporation**. This veil is a partition or curtain between the company and its members and is regarded as a **privilege** for the shareholders as it covers them in the corporate veil and keeps them from the reach of outsiders (creditors). However, such privilege of limited liability may not always exist in certain circumstances like when the legal personality of a company is abused and used for illegitimate or unlawful purposes. If it is shown that the legal personality has been abused and used to the detriment of third parties (creditors), the theory of legal personality (i.e. the separate and distinct existence of the company from that of its members) is disregarded and it is looked upon as a collection of persons instead of a collection of capital. Consequently, the individual member (s), director (s) and manager (s) will be held liable for the wrongs caused through the use of the legal entity. Hence,

when this is done by courts or by statute, it is said that the corporate entity is disregarded or the veil of incorporation is pierced which got its origin from the common law legal system particularly in England as a reaction to a rigid stand of the House of Lords on a famous decision that is known for establishing the principle of distinct entity of the corporation. Expressing in other words, the doctrine of piercing the corporate veil is an exception to the general rules of limited liability and separate corporate personality and exercised in certain circumstance with the view to achieving certain objectives including but not limited to compensation for the corporate creditors (protection of creditors), prevention of unjust enrichment of the shareholders, deterrence of future improper conduct.

Though a great deal of literature have been written about the circumstances under which the corporate entity is pierced in the common law legal system, a consistent guiding principle has not yet evolved to govern the circumstances in which a court should pierce the corporate veil. Hence, the corporate veil doctrine is non-conclusive and exhibits the **open-endedness** of a standard in which the courts make a determination based on notions of fundamental fairness and justice on a case-by-case basis. Some of the grounds for piercing the corporate veil in the common law legal system, as observed from some class of cases which have precedent value, include **fraud exception** (when the incorporation of a company is a sham or facade used to mask the real situation); **to establish single economic entity** (when there is a unity of interest and ownership between the corporation and its owners that their separate personalities have ceased to exist in reality); on the **ground of agency** and for the interest of justice.

Although the doctrine of piercing the corporate veil has its origin in the common law legal system, it has also influenced the countries of the civil law legal system in particular France. Unlike the common law legal system, there are few grounds by which the corporate veil is pierced under French law which could be either statutory (like bankruptcy) or judicial piercing.

As we have seen above in detail, the Commercial Code of Ethiopia has provided some clear statutory solutions to the most important aspects of piercing the corporate veil. These clear statutory grounds include the case of bankruptcy of the company where the assets are found to be insufficient to meet its debts; failure to discharge duties diligently where the directors will be held liable to the company's creditors if they fail to preserve intact the company's assets; during reduction of members of a share company below the required legal minimum; in case of parent-subsidiary companies if the parent company acts as a director of the subsidiary company.

Moreover, the writer tried to highlight other **possible grounds** which may call for the application of the doctrine of piercing the corporate veil in the Ethiopian legal system. These possible grounds include the liability of the directors to the company's creditors if they make fictitious dividends with the intention of under capitalizing the non-family company; during reduction of members of a private limited company below the required legal minimum; in case of defective formation of a company; in case of trade restraint where a person establishes a company to evade obligations, legal or contractual; and in case of sister-brother companies if there is no substantive separation as between themselves.

Moreover, the writer analyses some real cases with a view of surveying what is going on in Ethiopian courts in practice and to show the role of Ethiopian courts in applying the doctrine of piercing the corporate veil for non-statutory grounds.

5.2. RECOMMENDATIONS

In general terms, the clearly provided statutory grounds of piercing the corporate veil under Ethiopian law are limited in number. So, it is recommended, as Ethiopia is on the eve of enacting a new Commercial Code, that the legislative reform should consider and provide additional holes for piercing the corporate veil. Particularly, since the new (draft) Commercial Code has recognized and introduced a one man company in to the Ethiopian legal system, it is necessary to provide sufficient rules to regulate the possible abuses of the sole owner which include the provision of enough grounds of statutory piercing. Moreover, Ethiopian Courts (judges) are not proactive enough in applying the doctrine of piercing the corporate veil though some attempts are made to that effect.

This may be, as argued by Selamu, due to the narrow perception that Ethiopia is following a codified legal system and the only role of the judges is to ascertain the law in a Code form. However, the Ethiopian company law is influenced by both the common and civil law legal systems. Moreover, following a civil law legal system does not necessarily mean that the judges are limited and bound solely by the legal provision of the Code. They have discretion to be inquisitive and flexible in the interest of justice and this reality is clear if we look at the role of judges in court proceedings as provided in the Civil Procedure Code.

Since the very purpose of courts is to render justice, they should have discretion to pierce the corporate veil on grounds other than those provided by law if doing so serves the end of justice. Hence, the writer recommends that the courts should exercise the doctrine of piercing whenever justice or public policy so require; and where rights of innocent parties are prejudiced; whenever one in control of a corporation uses that control, or uses corporate assets to further his or her own personal interests. Putting it differently, the judges should be proactive to serve justice and may use the doctrine of **judicial activism** to pierce the fiction of separate legal personality and limited liability shield. Particularly, the cassation bench should play a great role in this regard as it is empowered to give decision on cases which have a fundamental error of law which ultimately serve as a precedent to all other courts. Since the interpretation of the cassation bench is expected to consider economic, social and political objectives and whose power tantamount to law making through interpretation, it can play a great role in exercising judicial piercing for the sake of justice.

This being the general recommendation regarding the issue at hand, the specific recommendations are provided as follows.

First, in a share company, failure to maintain the minimum required number of members may lead to the dissolution of the company and liability of the remaining members, who are aware of such reduction for the debts of a company. However, if the number of members of private limited company goes below two or where the organs of the company cease to exist, the only remedy available to creditors is requiring the dissolution of a company. There is no clear provision allowing the creditors of private limited companies to hold the remaining members personally liable. Since the purpose

of both provisions seems similar- i.e. protection of creditors' interest- there is no valid reason for the legislator not to give similar protection to creditors of private limited company by allowing them to extend their hands to the remaining member. Therefore, the law has to be modified to include such provisions or the courts should render justice by extending the provision provided for share companies by analogy.

Second, under Ethiopian law, a company will have a legal personality though defectively formed, so long as it is properly registered and published. However, if such defective formation is detrimental to the interests of creditors or shareholders, the court may order the dissolution of a company upon the application of the former. Though the law is not clear as to the liability of the shareholders upon the dissolution of such defectively formed share company, the rationale for ordering the dissolution of a company by the court is to **protect the interest of creditors**. However, the dissolution of a company alone will not fully protect the interests of creditors. Hence, to fully protect the interests of creditors, the legislator should provide a statutory mechanism to pierce the veil of a company, in addition to dissolution, to make persons responsible for defective formation- i.e. founders or all shareholders in case of a closely held share company- liable for the debts of the company. Alternatively, the courts should be guided by the doctrine of piercing the corporate veil to fully protect the interests of creditors in this regard. Unless this doctrine is followed in such a situation, the founders may shift their personal liability, which otherwise would have been imposed on them if the company fails to get legal personality,²⁶⁷ to the company by causing the registration and publication of a defective company to be effected and thereby claiming separate legal personality as per Art. 324 (2) of the commercial code.

Third, though the Commercial Code recognizes the idea of group of companies, it does not take care of the possible abusive conducts of the parent company which may prejudice the minority shareholders and creditors of the subsidiary company. To protect the abusive conducts of the parent company and ultimately to maintain the interests of

²⁶⁷ Supra note 1, Art. 308 and Art. 309. If the company fails to be registered and fails to get personality for whatever reason, the founders themselves are jointly and severally liable for any commitments they entered in to. However, if the company gets legal personality, it will take over all the commitments from the founders and refund the founders with all the expenses made by them in so far as such commitments and expenses were necessary for the formation of the company or approved by the general meetings of the subscribers.

the subsidiary's creditors, different countries' company laws provide sufficient grounds for piercing the corporate veil of the parent company. Some countries, in addition to piercing the corporate veil rule, also provide **special regime** for regulating group companies to protect creditors by giving the subsidiaries creditors the right to proceed against the parent company without the need to prove any abusive acts of this parent company. In Ethiopia let alone providing a special regime for regulating group companies, the existing law does not provide sufficient grounds for piercing the veil of the parent company.

The only available ground of piercing the corporate veil of the parent company is when it acts as a director of the subsidiary and when it fails to perform its duties imposed by law, the memorandum or resolution of meetings of share holders which consequently leads to the insufficiency of the assets of the subsidiary or during **bankruptcy**. Therefore, there are no other extensive statutory grounds of piercing in case of corporate groups so as to make the parent company liable for the debts of the subsidiary in the event when the parent company is not appointed as a director of the subsidiary under Ethiopian law. Hence, the legislative reform should consider and provide other grounds of piercing the corporate veil in corporate groups (parent-subsidiary Company) to avoid the abusive behaviors of the parent company and to effectively protect the minority shareholders and creditors of the subsidiary company. Alternatively, the judges should play a pro-active role in the interest of justice.

Similarly, in case of brother-sister companies, it is obvious that, there is a unity of interest and ownership between the corporation and its owners that their separate personalities have ceased to exist in reality and there is an overlap of corporate personnel and management. Despite this fact, the Ethiopian law does not provide a clear provision which make the sister-brother companies liable if one of them become unable to pay their debts. Hence, the writer recommends that the legislator should promulgate adequate and relevant law which provides sufficient statutory hole to pierce the corporate veil of the brother-sister companies or the judges should play a pro-active role in the interest of justice to pierce the veil by considering them as a single economic entity, **not per se**, but after proof of abusive activities as between themselves.

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APPENDICES/ANNEXES