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COLLEGE OF LAW AND GOVERNANCE STUDIES

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SHAREHOLDER AGREEMENTS IN THE LIGHT OF THE NEW COMMERCIAL CODE OF ETHIOPIA: THE CASE OF PLCS

BY

KALKIDAN SEWAGEGNE

ADVISOR

FEKADU PETROS (Assistant Prof.)

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A THESIS SUBMITTED TO THE COLLEGE OF LAW AND GOVERNANCE STUDIES OF ADDIS ABABAUNIVERSITY IN PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE OF MASTERS IN BUSINESS LAW (LLM)

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FEKADU PETROS (Assistant Prof.)

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Approved by:

Fekadu Petros (Assistant Prof.) _____ _____

Advisor's Signature Date

Yazachew Belew (Assistant Prof.) _____ _____

Examiner's Signature Date

Zekarias Keneaa (Associate Prof.) _____ _____

Examiner's Signature Date

Declaration

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

Kalkidan Sewagegne Delele

Signature_____

Date _____

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Acronyms

AoA: Articles of Association

DARS: Document Authentication and Registration Service

MoA: Memorandum of Association

PLC: Private Limited Company

S.C.: Share Company

PE: Private Equity

SHA: Shareholders' Agreement

VC: Venture Capital

Abstract

Shareholders of a PLC may conclude SHA that exists beside the MoA to control the operation of the business and regulate the relationship amongst themselves. These agreements are not required to be entered into the commercial register as they don't form part of the MoA. Authentication and registration are also not validity requirement for SHA in Ethiopia, unlike the case of MoA. Therefore, these agreements are kept confidential and contain classified information. As a result, parties tend to include provisions that are inconsistent with the Commercial Code and the MoA of the companies.

The Commercial Code's silence on the existence of SHAs and their content leads to questions about their legal basis and the extent to which parties' freedom of contract is honored. To properly address the issues, both doctrinal and non-doctrinal methods of conducting research have been used. Consequently, the research findings revealed that the agreements are treated as any other contracts; however, provisions in a SHA that are inconsistent with the provisions of the commercial code or the MoA could face challenges in enforceability.

Key Words:

PLC, MoA, Commercial Code, SHA

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Chapter One

Introduction

1.1. Background of the Study

Any company is formed with the sole intent of conducting business and making profit. The commercial code of Ethiopia also defines a business organization as a legal entity created with the intention of engaging in economic activity and sharing in any profits made.[1] However, establishing a company is challenging because it demands both financial and human resources.[2] In order to fill these gaps, business owners, mostly startups or small businesses, invite private investors to inject capital into their businesses. In exchange for shares in the company, investors will invest in a company that they believe has significant growth potential.

When operating a business, business partners will inevitably face disagreements in relation to their rights in the company. Prudent investors, who invest in an investee firm or company, do not wait until situations that affect their rights to occur before seeking solutions. Instead, they foresee potential issues at the time of investing and put in place mechanisms to address them to avoid unnecessary complexity.

Of course, in Ethiopia, the Commercial Code and Memorandum of Association (MoA) of individual companies are in place to establish the relationship between the shareholders and the company as well as between the shareholders inter se. However, the law and the MOA might not be sufficient to determine and address problems arising among partners in business.[3]In such a case, a Shareholder agreement (SHA) plays a vital role in governing parties' relationships and reducing conflicts.

Written or oral agreements between shareholders that provide reciprocal rights and obligations in addition to those granted by the law and the company's constitutional document (MoA) are known as SHAs.[4] When the rights and obligations set forth by law and regulation are deemed inappropriate or insufficient, shareholder agreements define the rights and obligations of

[1] Commercial Code Proclamation, 2021, Art. 172 (1), Proc. No. 1243, Neg. Gaz. Year 27 no. 23

[2]Keshav Kaushik & Soumi Chatterjee, 'Significance of Shareholders' Agreement &its Enforceability in India: A Critical Study' (2022) 13 Journal of Algebraic Statistics 2185

[3]ibid 2187

[4]JelenaPajic, 'Share Transfer Restrictions and Exit Mechanisms in Shareholders' Agreements' (2012) 7 GSI Articlletter 21

shareholders.[5]In addition to the legislation and the constitutional documents of companies, the shareholders' agreement is a document that is essential in defining the relationship between the shareholders and the company as well as among the shareholders themselves.

This paper will look into whether there is a legal basis for SHA in PLCs, the subject matters covered in SHA, and their enforceability under the Ethiopian legal system.

1.2. Statement of the Problem

Finance is essential to a company's operation. Thus, shareholders contribute to the firm's financing by purchasing shares. When working together, it is preferred for partners to put a shareholder agreement in place to control the operation of the business and regulate the relationship amongst shareholders. SHAs are essential to protect a shareholder's rights in a company and establish guidelines for handling conflicts between shareholders and shareholders and companies.

Shareholders have certain rights inherent to their shareholding. However, a shareholder's agreement provides other rights to those shareholders who are parties to the agreement, which are over and above the rights that are inherent in the shares that they own.[6] SHA exists besides the constitutional documents of companies. The parties will not make SHAs part of the MoA because MoAs are required to be entered into the commercial register as per Art.499(1) of the Commercial Code, and according to Art. 75 of the same and Art.7 (3) of the Commercial Registration and Licensing Proclamation No. 980/2016 the commercial register is open to the general public. Moreover, the Authentication and Registration of Documents' Proclamation No. 922/2015 doesn't require SHAs to be registered and authenticated by DARS, unlike the constitutional document of a company. Therefore, these agreements are private documents that are kept confidential by the parties who signed them[7] and contain classified information. As a result, those investors who put capital into businesses use the agreement to reserve for themselves rights that are not given to them by the law or the memorandum of association, with a view to controlling the management and operation of the company. On the other hand, parties to a contract have freedom of contract unless

[5] Gilles Chemla, Michel A. Habib & Alexander Ljungqvist, 'An Analysis of Shareholder Agreements' (2007) 5 Journal of the European Economic Association 93

[6] The Corporation Law Committee of the Association of the Bar of the City of New York, 'The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions' (2007) 65 The Business Lawyer 1155

7 Mike Volker, 'The Shareholders Agreement' <https://www.sfu.ca/~mvolker/biz/agree.htm>, accessed 15 December 2022

this right is restricted by law for different reasons.[8]Though this provision tells us about the parties' freedom of contract, the researcher did not find any empirical evidence that shows the fate of the agreements in case they contradict the commercial code provisions and the memorandum of association of the PLCs. Therefore, this paper will attempt to assess the existence of legal restrictions on parties' freedom of contract in this respect and the enforceability of SHAs that contradict the Commercial Code and the PLCs' memorandums of association in Ethiopia.

1.3. Objective of the Study

1.3.1. General Objective

The general objective of the study is to examine the subject matters regulated by SHA and the validity and enforceability of those agreements in light of the Commercial Code provisions and the Memorandum of Associations in the context of PLCs.

1.3.2. Specific Objectives

The specific objectives of the study are:

- To assess the familiarity of legal professionals as to the legal basis for SHAs in PLCs in Ethiopia.
- To analyze the subject matters regulated by shareholder agreements in Ethiopia.
- To examine whether SHAs that contradict the Commercial Code provisions and the Memorandum of Associations can be enforceable.

1.4. The Research Questions

The study mainly focuses on answering the following research questions:

- Are legal professionals familiar with the legal basis for SHAs in PLCs in Ethiopia?
- What are the subject matters regulated by SHAs in Ethiopia?
- Can SHAs that contradict Commercial Code's provisions and Memorandum of Associations be enforceable?

1.5. Scope of the Study

The scope of the research is limited to SHAs in PLCs. The very focus of this study is examining and identifying relevant laws concerning SHAs. In addition, judges of the First Instance Court,

[8] Civil Code of the Empire of Ethiopia Proclamation, 1960, Art 1711, Proc. No 165, Neg. Gaz. Year 19, no 2,

High Court, and Supreme Court were participants in this study. Furthermore, practicing lawyers who are working in law firms were involved in the research.

1.6. The Research Method

To address the research questions, the research employed both doctrinal and non-doctrinal research methodologies. With regard to data sources, both primary and secondary sources are considered in the doctrinal method. Accordingly, primary sources such as the Commercial Code of Ethiopia, the Civil Code Proclamation of 1960, and other relevant statutes are used. As a secondary source, the SHAs of five companies and various kinds of published and unpublished materials on the topic are considered. As to the non-doctrinal method, the primary data is collected from interviews with eight federal judges from different levels of federal courts, three practicing lawyers from prominent law firms in Ethiopia, and three branch managers of Document Authentication and Registration(DARS) who were selected using the purposive sampling method. Relevant books, articles, and other relevant materials are used as secondary sources.

Lastly, data collected from primary and secondary sources is presented and interpreted using a qualitative analysis method.

1.7. Significance of the Study

This study is significant for three reasons. First, it adds some knowledge to the existing pull on the topic. Second, it investigates the laws that govern SHAs and provides insight for policymakers on how to improve them. Lastly, it would be a background document for students and researchers who are interested in conducting further research on the topic.

1.8. Limitation of the Study

The researcher found no publication on this particular subject in Ethiopia. In addition, as the agreements are confidential, most practicing lawyers are not willing to disclose them even though it is for academic purposes. For this reason, the researcher only managed to find five SHAs. Furthermore, it was too tough to interview the participants and accomplish the tasks on time. Some of them didn't respect their appointment, which limited the researcher from obtaining diversified information.

The above-mentioned limitations may have compromised the quality of the research findings.

1.9. Organization of the Paper

This research paper is organized into five chapters. The first chapter provides an introduction, statement of the problem, objective of the study, research questions, scope of the study, research methodology, limitations and significance of the study. Chapter two describes and analyzes relevant literature. Chapter three deals with analyzing the legal basis for SHAs, matters regulated by SHAs in Ethiopia, and the need to have SHAs in Ethiopia. Chapter four of the study deals with the authentication and registration of SHAs and the enforceability of SHAs that contradict the law and the MoA of the companies. The last chapter, which is chapter five, will draw conclusion and recommendations.

Chapter Two

Theoretical and Conceptual Underpinnings of Shareholders' Agreement

2.1. Introduction

This chapter deals with concepts relating to SHAs, major issues addressed in them and the experiences of different countries as to their enforceability. In the following discussion, more attention is given to cases where provisions in the shareholders' agreement are in conflict with the constitutional documents and the company law and cases where the two documents are silent about a provision in a SHA.

2.2. Private Limited Company

A PLC is an enterprise in corporate form in which a share is held in a few hands[9] and whose share is not publicly traded. The company's shareholders are generally connected with one another through family ties or friendship.[10]

PLC is a company in which management and ownership are substantially identical. As a result of that identity, the participants consider themselves "partners" and seek to conduct corporate affairs to a greater or lesser extent in the manner of a partnership.[11] Shareholders in PLCs usually participate in the management of the corporation as directors, officers, or employees[12] and they represent the company in the market.[13] This participation or employment provides shareholders with a return on their investment.[14]

A company is mainly governed by three major documents: legislation, Memorandum of Association (MoA) and agreements and contracts.[15]

[9]Alex Elson, 'Shareholders Agreements, a Shield for Minority Shareholders of Close Corporations' (1967) 22 The Business Lawyer 449

[10]Hunter J. Brownlee, 'The Shareholders' Agreement: A Contractual Alternative To Oppression As a Ground For Dissolution'(1994) 24, Stetson Law Review 270

[11]Carlos D. Israels, 'Close Corporation and the Law ' (1947-1948) 33 Cornell Law Quarterly 488

[12]Brownlee (n 10) 270

[13]Kaushik & Chatterjee (n 2) 2185

[14]Brownlee (n 10) 270.

[15]Prateek Gupta, 'Shareholder's Agreement and Articles of Association: A Power Struggle' (2021) 4 international Journal of law, management and Humanities 1239

2.3 MoA and AoA

The fundamental terms under which a corporation may operate, including its purpose for formation, are described in the MoA. It is an essential document because it explains the fundamental principles guiding a business' operations and interactions with its shareholders and other stakeholders.[16] On the other hand, the rules and regulations governing a business or organization are outlined in the AoA. It serves as a basic document outlining the company's goals and operational procedures. The rights and obligations of its members and directors are usually outlined in the articles of association.[17]

MoA and AoA are two crucial governing documents of a company. The MoA officially establishes the company's existence, whereas the AoA deals with the regular management and control of the company and serves as the constitution of the company and its members.[18]The AoA includes a list of all the significant duties and authority that the corporation and its directors have. It also empowers the company to do or not to do something. Therefore, AoA hold utmost significance with respect to a company's governance and conduct.[19]

As we can understand from the above definitions, the MoA establishes the corporation, and the AoA specifies how it will be managed. Therefore, these two documents are essential for a company as they provide guidance to the business in many aspects. They also aid in the efficient management and operation of the business.

In addition to the MoA and AoA, which are public documents, a private SHA may be entered into to regulate shareholders affairs. This supplements the MoA and AoA on the company's operations, management, and ownership.

AoA was recognized under the former commercial code (Art.518 of the Commercial Code Proclamation of 1960). The AoA used to be more detailed than the MoA and was mostly used to govern the operations of the company. Since it is eliminated with the coming into force of the new commercial code, companies will not be forced to have an AoA. If they wish to have one, however, the commercial code doesn't prohibit them from having it. However, as officials of DARS do not

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[16]Pankaj Tyagi, 'Know the Difference Between Memorandum Of Association And Articles Of Association' 2002 <https://corpbiz.io/learning/between-memorandum-of-association-and-articles-of-association/#:~:text=Memorandum%20of%20Association%20refers%20to,rules%20that%20regulate%20the%20company> accesses 14 April 2023

[17]ibid

[18]Gupta (n 15) 1239

[19] ibid 1241

recommend companies to have AoAs because they create unnecessary piles of papers in their archive, companies are resorting to incorporating issues that used to be incorporated in AoAs into their MoAs.[20] They may also opt to conclude SHAs in order to incorporate matters that used to be governed by the AoA into the SHA. The Commercial Code made only the contents listed under Art.500 mandatory parts of the MoA. Other details that used to be governed by the AoA (the operation of the company) are matters that third-parties have no business knowing. These matters are better if they are made part of the SHA.

2.4. SHA and Its Purpose

It is possible to claim that the origins of companies can be found in both contracts and statutes. While the legislature supplied the corporate shell**,** contract law did much to flesh out the contents of that shell in terms of the relationships between the many stakeholders included therein.[21]

Parties to SHA may be some or all of a company's shareholders and, at times, the company itself.[22]It may also be made between existing and potential shareholders of a company.[23]SHA is an agreement defining the rights and obligations of shareholders when the ones set forth by law and the constitutional document of the company are deemed insufficient.[24] The agreement aims to highlight the multiple rights and obligations of shareholders, and it contains various issues.[25] SHAs are usually used when at least some shareholders are actively engaged in the management of the business.[26] The primary objective of SHA is to govern the details of the members' cooperation that

[20] Interview with Abinet Wondimu, Branch Manager of Branch 5 (Former Deputy Manager of Branch 10), Federal Document Authentication and Registration Service (10 July 2023); Interview with Damtew Yohannes, Branch Manager of Branch 12 (Former Deputy Manager of Branch 8) , Federal Document Authentication and Registration Service (10 June 2023); Interview with Menur Mehamed, Branch Manager of Branch 10, Federal Document Authentication and Registration Service (22 May 2023)

[21]Michael J. Duffy, 'Shareholders Agreements and Shareholders' Remedies Contract Versus Statute?' (2008) 20, Bond Law Review 1

[22]Orr Litchfield Solicitors and Business Lawyers, 'Shareholders' Agreements' <https://www.orrlitchfield.com/Limited_Companies/Shareholders_Agreements> accessed 27 September 2023

[23]Kaushik & Chatterjee (n 2) 2185

[24]Chemla, Habib &Ljungqvist (n 5) 93

[25]Shriya Mishra, SeharSethi & Pragya Chhabria, 'Conflict between the Shareholder's Agreement and Articles of a Company' (2022) 5 International Journal of Law, Management and Humanities 1893, p 1894

[26]Chemla, Habib & Ljungqvist (n 5) 94

the parties are not intending to make public and whose publicity is not required by company law or business registration law.[27]

It has been argued that the principle of majority rule applies at all levels of authority in companies.[28] So when the minority shareholder is a member of a normal close corporation where the shareholders, directors, and officers are all the same people, he might not have an effective voice at any level and thus be powerless to prevent the harms.[29] Even when they do not own a majority of the company's shares, investors demand some degree of authority in the company, which comes in different forms. Therefore, the other major objective of a shareholder agreement is to end the rule of the majority and bestow investors with rights that go beyond what they would have only by way of their total percentage ownership of the business.[30]

2.5. Major Issues Addressed in SHAs

The major issues addressed in SHAs include ownership (restrictions on share transfers), the conduct of business and management of the company, and exit mechanisms, i.e., exiting the investment.

2.5.1. Ownership (Restriction on Share Transfer)

Investors want to ensure that ownership of the company cannot significantly change without their approval. Founders and other significant shareholders are nearly always required to consent to some transfer restrictions.[31] Limitations may take the form of outright transfer restrictions, right-of-first-offer/right-of-first-refusal clauses that allow transfers but only after giving the investor or other shareholders the option to purchase the shares, or both.[32]

2.5.1.1. Right of First Refusal (ROFR)

Such a clause aims to guarantee that any shares that any shareholder wishes to sell are available for purchase by the company and/or the shareholders prior to selling to an outsider. By using this approach, shareholders make a commitment to only sell their shares after negotiating a price with

[27]Tamas Sarkozy, 'Shareholders' Agreements' (2002) 43 Acta Juridica Hungarica. 119, p129

[28] Duffy (n 21) 5

[29]Elson (n 9) 452

[30]Daniel T. Janis, 'Venture Capital Shareholder Agreements - More Attention Now, less Heartache Later' (2017) 2017 Business Law Today, p 1

[31] ibid

[32] ibid

a third party and then making the shares available to the existing shareholders at that price.[33] The selling shareholder will be allowed to sell to third parties within a specified time frame if the other shareholders do not make use of their privilege to purchase the shares that have been made available to them.[34]

Therefore, the right of first refusal empowers the other shareholders and/or the company to be informed of an offer that a shareholder intends to accept in order for them to have the option to purchase the shares at the same price and term.

2.5.1.2. Right of First Offer (ROFO)

Under the right of first offer, the selling shareholder may look for a higher offer from third parties; however, he is not permitted to offer the shares to a third party at a lower price or on terms that are less favorable to the selling shareholder than those offered by the other shareholders and/or the company.[35] The selling shareholder must first request proposals from the existing shareholders, and he may sell the shares to a third party only if he is able to obtain a more advantageous offer from the third party.[36]

Thus, ROFO provides that a shareholder who wants to sell their shares must first offer them to a shareholder in whose favor a ROFO is granted, who may then propose a price for the shares being sold. If the selling shareholder fails to secure a higher price from a third party, then he may sell to that shareholder.

2.5.1.3. Mandatory Sale Provisions

A mandatory sale provision compels a shareholder to sell his or her shares to the company or to other shareholders under certain conditions, such as upon death, or disability, or retirement. Such clauses may be incorporated into SHA to preserve a small group of shareholders and/or maintain the continuity of ownership of the company in question.[37]

[33]Brownlee (n 10) 303

[34]Pajic (n 4) 23

[35] The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1178

[36]Pajic (n 4) 24

[37]The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1180

2.5.2. Conduct of Business and Management of the Company

2.5.2.1. Minority Veto Power:

These arrangements ensure that minority stockholders have a voice in the corporate decision-making process. These provisions provide minority shareholders with veto power over the actions of controlling shareholders.[38] Securing veto power may be achieved by raising the number or percentage of shareholders or directors both for quorum purposes and for the purposes of taking action.[39]

2.5.2.2. Preemptive Rights:

A preemptive right guarantees that some or all of the shareholders will have the right to buy more shares and/or other equity securities that the company intends to issue in the future.[40] A preemptive right clause could also compel the company to offer preferred shares to minority owners when earnings fall, guaranteeing that they will be the first to receive dividends. The right may be provided under other mutually agreed-upon conditions.[41]

2.5.2.3. Special Voting Rights

SHAs usually contain clauses that forbid the corporation from acting in a certain way unless it has the consent of specific shareholders, or a percentage of those shareholders, and/or a specific director(s) or a percentage of the directors chosen by specific shareholders.[42]As a method of protecting its investment, a minority shareholder can demand having the power to approve specified actions. For instance, a minority shareholder(s) may claim that no share transfer should occur without his/their prior approval.

2.5.2.4. Quorum Rights:

Investors can prevent specific topics from being discussed in a meeting by claiming quorum rights in the event that a certain member, or director, or class of members is not present. If the designated person is not present, this privilege would cause the meeting to be invalidated even if the legally required quorum is present.[43]A private equity investor would often demand the presence of their

[38]Brownlee (n 10) 304

[39]Elson, (n 9) 452

[40]The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1191

[41] Brownlee (n 10) 307

[42]The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1170

[43] Gupta (n 15) 1243

representative or nominee in meetings, and the lack of such a representation or nominee in meetings would make the quorum to be regarded as an invalid quorum.[44]

2.5.3. Exit

2.5.3.1. Tag-Along Rights (Co-sale rights):

A tag-along clause demands that shareholders who are planning on selling their shares to an external purchaser extend the chance for the other shareholders to participate in the sale. The tag-along right enables the holder to sell a proportionate amount of his shares to the same buyer at the same price and terms and conditions.[45] Thus, the selling shareholder has to inform the shareholder with the tag-along right of the intended sale, following which the latter must decide whether to exercise his tag-along right by participating in the transaction.[46] The purpose of tag-along is to protect the minority shareholder from the unknown (or known) behavior of the new controller.

2.5.3.2. Drag-along rights

A drag-along clause requires other shareholders to sell their shares at the same price and under the same conditions as the shareholder using the drag-along right. This right bestows the ability to sell a larger portion of the company than they currently control and hence receive a better sale price, and this is what makes a drag-along right appealing to shareholders.[47] Thus, when an investor finds a buyer, drag-along rights empower it to compel other shareholders to sell their shares. Drag-along rights facilitate exits. Most new controllers would want a majority stake in the company, and would hesitate to buy a smaller percentage of the departing shareholder or pay good value.

2.6. Validity and Enforceability of SHAs

Agreement negotiation is a critical component of all big equity investment transactions, particularly when investment companies intend to hold a minority stake in the target company. When investing in a company, the investor aspires to be a part of the company's management and to be able to easily transfer his shares.[48] SHA includes several of the fundamental rights that investors aim for, although it is usual practice for the MoAs to lack particular provisions for

[44]ibid

[45]The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1185

[46]Pajic (n 4) 22

[47]The Corporation Law Committee of the Association of the Bar of the City of New York (n 6) 1182

[48]Gupta (n 15) 1243

securing the same. Furthermore, SHAs frequently include clauses that are not covered under the Companies Act. As a result, the enforceability of SHA is called into question.[49]

Some argue that nothing prohibits the parties from regulating matters in the SHA that were not covered by the constituting documents or were outside the purview of company law.[50] While others believe that, though the legal principle of "freedom of contract" regulates many terms of a normal SHA, there are various legal concerns that will affect its enforcement and efficacy. However, issues may arise when a SHA goes beyond conventional rights and procedures and attempts to legitimize an action that would otherwise violate company law rules. [51]

Investors move to secure their rights using SHAs. Therefore, they have to make sure whether such an arrangement is enforceable or not in the eyes of the courts of the country and the governing law. Thus, this study tries to address the experiences of some countries as to the validity and enforceability of SHAs.

The US Model Business Corporation Act states that SHA is binding on the shareholders and the corporation, even if it is inconsistent with one or more provisions of the Act. In addition, SHAs are valid whether they are stated in the articles of incorporation, bylaws, or in a separate agreement.[52]

Similar to the US Model Business Corporation Act, the Florida Business Corporation Act allows shareholders of companies with 100 or fewer shareholders to have SHAs. It also states that the agreement is effective among the shareholders and the company, even though it is inconsistent with one or more provisions of the chapter.[53] Section 607.0732 provides for an exhaustive list of forms of SHAs that are valid, even if they violate other requirements of the Florida Business Corporation Act.[54] Nevertheless, SHAs made under Section 607.0732 should be incorporated in the company's articles of incorporation or bylaws and authorized by the shareholders at the time the agreement is made.[55]

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[49]ibid 1239

[50] Sarkozy (n 27) 129

[50]Duffy (n 21) 5

[51] ibid

[52] Model Business Corporation Act (Revised), 2017, Section 7.32(a) & (b)

[53] Florida Business Corporation Act, 1993, Section 607.0732(1)

[54]Brownlee (n 10) 299

[55] Florida Business Corporation Act (n 53) Section 607.0732(2)(a)(1)

In Hungary, without taking into consideration a few special requirements of the Part of the Civil Code on general rules of obligations, SHA as a regular contract is almost entirely governed by optional rules, which leaves a lot of room for meeting the parties' intentions.[56]

The matter will be problematic where the provisions of the SHA are inconsistent with the rules of the company law, and there could be three possibilities, i.e., 1. he SHA is inconsistent with non-mandatory provisions of the company law;2. it contradicts the mandatory provisions of the company law; or 3. the clauses in the SHA are not in clear conflict with the law but they incorporate provisions not included in it.

In the first case, the arbitration practice in Hungary often allows the parties to deviate from the non-mandatory provisions of company law. In the second case, the arbitration practice considers the provisions of the SHA that contradict the mandatory provisions of company law, or the entire SHA, to be an illegal contract and hence unenforceable.[57] In the last case where the company law is silent on a provision in a SHA, the arbitration practice in Hungary is inconsistent.[58]

In New York, concerning provisions as to classification of shares, in the case of Abbey v. Meyerson, there was an agreement that stipulates the company's administration and operation shall be controlled solely by those holding Class B shares and that Class A shareholders will not get involved with said management as they were only expected to nominate, vote for, and elect leaders of the company holding Class B shares.[59] The court states that the stipulations of the agreement have the effect of depriving the board of directors of their authority and functions and vesting management in the holders of Class 'B' shares. Thus, such an agreement is null and unenforceable since it contradicts the terms of Section 27 of the General Corporation Law and state public policy.[60] With respect to agreements as to quorum and vote concerning a by-law requiring that the directors of the corporation be elected by unanimous vote of all stockholders, the court held that such a rule, whether incorporated in the certificate of incorporation or in a by-law, was "unlawful because it violates a crucial component of state policy." This means it specifically violates Section 55 of the New York Stock Corporation Law, which states that directors must be elected "by a

[56]Sarkozy (n 27) 129

[57] ibid 132

[58]ibid

[59] Juan L & Jr. Luna,' Protection of Minority Interests through Stockholders' Agreements: A Commentary on Section 9 of the New York Stock Corporation Law' (1953) 28 Philippine Law Journal. 506, p 514

[60] ibid

majority of the votes cast at such an election."[61] Therefore, it can be inferred that courts in New York will not enforce SHAs that contradict the law.

In India, the AoA is a document regulated by the Companies Act, 2013, that contains norms for internal regulation that must be followed by the company's shareholders, directors, and members. A SHA, on the other hand, is a kind of contract governed by the Indian Contract Act of 1872 that specifies the shareholders' rights and obligations. The terms of the AoA and the SHA sometimes contradict each other, making it difficult to determine whether to rely on the AoA or the SHA.[62] The Supreme Court and High Courts of India have ruled in several instances that elements of the SHA that are against the company's AoA as not legally binding on the parties and the company.[63] In the event of a conflict between the SHA and the AoA, the latter will take precedence.

However, Indian courts rendered inconsistent judgments when the AoA was silent about a certain clause in a SHA that was not in conflict with the Companies Act. In the case of World Phone India Ltd. vs. WPI Group Inc., the Company Law Board ruled that although clauses of the SHA were not included into the AoA, they would still be enforceable.[64] However, the Delhi High Court ruled that if a company's articles are silent on the presence of a clause, it is impossible to say a provision in a SHA would be binding without being incorporated into the articles.[65]Therefore, a provision in the SHA that fails to appear in the AoA but does not violate the Act is unenforceable

In the case of V.B. Rangaraj vs. V.B Gopalakrishnan and different other cases, the Supreme Court ruled that the section in the SHA restricting the shareholder's power to transfer shares should be included in the AoA in order for it to be enforceable.[66] However, in the case of Vodafone International Holdings BV vs. Union of India, the Supreme Court disagreed with the Rangaraj case, holding that if the clauses in the SHA are not inconsistent with the clauses in the AoA, and the AoA is silent on the clauses in the SHA, then the provisions in the SHA would be maintained and would have a contractually binding effect on the shareholders and the company.[67] In addition, in the case of Premier Hockey Private Ltd vs. Indian Hockey Federation, the Supreme Court

[61]ibid 527

[62]Kratee Aggarwal, 'What Overpowers the Other: Shareholder Agreement or Article of Association: The Indian Position' (2021) 4 International Journal of Law, Management and Humanities 4019, p. 4019

[63]Gupta (n 15) 1245

[64] Mishra, Sethi & Chhabria (n 25) 1897

[65]Gupta (n 15) 1245

[66]Mishra, Sethi & Chhabria (n 25) 1896

[67]ibid 1897

decided that, so long as the clauses do not violate any law or the company's AoA and are beneficial to the company, clauses of the SHA that were not incorporated in the AoA are enforceable.[68]

When the provisions of the SHA go against the provisions of the AoA, the AoA shall take precedence and be enforceable. On the other hand, as tried to demonstrate in the above cases, the Indian courts rendered inconsistent judgments in cases where the AoA was silent on the matter, as some decisions favored the enforceability of a clause in the SHA while some are against its enforceability.

[68]ibid 1901

Chapter Three

Shareholder Agreements in Ethiopia

3.1. The legal basis of SHAs in private limited companies in Ethiopia

According to the Commercial Code of Ethiopia, a PLC is a business organization whose shares are not open for public subscription. It may not have less than two or more than fifty members.[69] The Commercial Code requires two conditions to be fulfilled for the formation of a PLC in Ethiopia. A PLC is formed when its capital is fully paid-up and the MoA is entered in the commercial registrar.[70] From this, it can be inferred that the only constitutive document of a PLC in Ethiopia is the MoA, as the AoA is eliminated from the picture with the coming into force of the new Commercial Code.

Among other things, the MoA should cover the relationships among the company's management, the company and its members, and the shareholders. In addition, it may also include anything that is required by law or by members' agreement.[71] The discretion to regulate the matters that shareholders deem necessary, other than those indicated by law, was not given to shareholders of a company under the previous commercial code. As discussed in the previous chapter, the governance of the above-mentioned matters is one of the reasons why shareholders opt to conclude a SHA. Even though regulating the relationship among shareholders and the company and its members and any other matter that shareholders consider important is now permitted in the new commercial code to be regulated by MoA, shareholders of companies still continue to conclude a SHA in order to govern matters that they believe are private and confidential, as MoA is a public document and is required to be entered in the commercial registrar.

All the judges and lawyers involved in the interview believe that SHAs are contracts and governed by law of contracts as long as they comply with the requirements of the Civil Code. The Civil Code of Ethiopia defines a contract as an agreement between two or more people that creates, modifies, or terminates obligations of a proprietary nature.[72] The law provides four elements of a contract that are required for it to be valid. The first element is capacity.[73] Parties that intend to

[69]Commercial Code proclamation (n 1) Art. 495 (1), (2) & (4)

[70] ibid Art 499 (1)

[71] ibid Art 500 (14) & (15)

[72]Civil Code of the Empire of Ethiopia Proclamation (n 8) Art.1675

[73] ibid Art.1678(a)

enter into a contract should have the legal capacity to do so. The second element of a contract is the consent of the parties.[74] A contract depends on the consent of the parties, who specify the object of their obligations and agree to be bound by them.[75] Thus, they have to give their free consent to be bound by the contract they are entering into. The third element of a contract provided by law is object. The object of a contract has to be sufficiently defined,[76] possible,[77]lawful,[78]and not immoral.[79] Finally, the contract should be made in the form prescribed by law, if any,[80] or in the form stipulated by the parties.[81]

In addition to the above requirements, even though parties have freedom of contract, they shall determine the content of the contract pursuant to the mandatory provisions of the law.[82] Hence, the provisions of a contract cannot violate the mandatory provisions of the law.

Taking the above explanation into account, if persons reach an agreement by which they define their relationship by providing terms and conditions, it can be said that the parties have entered into a binding obligation, i.e., a contract, so long as they comply with the aforementioned requirements of the law. Therefore, a SHA is a contract inasmuch as it adheres to the requirements stipulated by the law.

In addition, Book IV of the Civil Code, which deals with obligations, applies to all contracts, regardless of their nature or the parties.[83] Hence, Book IV applies to SHAs.

3.2. Subject Matters Regulated by SHAs in Ethiopia

Ethiopia is no exception when it comes to the utilization of SHAs by companies, specifically PLCs. Most SHAs in Ethiopia are concluded by private equity (PE) investors.[84]PE is the investment of

[74] ibid Art.1678(a)

[75] ibid Art.1679 (1)

[76] ibid Art.1678 (c)) & Art 1714 (1)

[77] ibid Art.1678 (c) & Art 1715

[78] ibid Art.1678 (c) & Art 1716 (1))

[79] ibid Art.1716 (1)

[80] ibid Art.1678 (c) & 1719 (2)

[81] ibid Art 1719(3)

[82] ibid Art.1731(2)

[83] ibid Art.1676(1)

[84]Interview with Beakal Abate, Partner, Aman & Partners LLP (31 May 2023); Interview with Getu Shiferaw, Partner, Mehreteab and Getu Advocates LLP (13 June 2023); Interview with Mesfin Tafesse, Principal Attorney, Mesfin Tafesse and Associates Law Office (25 May 2023)

equity funds to privately held businesses. In a PE transaction, an investor purchases a share in a private company with the expectation that the value of the share will increase in the future.[85]

The two major activities of a PE firm are typically raising capital and investing in high-potential private enterprises.PE investments often have a short to medium-term lifespan, and the objective is quick company growth. PE firms often work to swiftly realize the value of their investments since they have a contractual obligation to do so for their limited partners.[86]Since these investors' plan is to increase the value of their investment, relinquish their shares, and leave the company within a certain period, they require a comprehensive contract to protect their interest.

In this sub-section, this research looked into matters that are mostly regulated by SHAs in Ethiopia. To this end, the researcher reviewed the SHAs of five PLCs. However, even though they are found in the hands of the researcher, because of the confidential nature of the agreements, for the purpose of this research, they are referred to as Company A,B,C,D, and E.

Common topics covered by SHAs in Ethiopia include ownership and transfer of shares, decision-making, management and board composition, dispute resolution, exit mechanisms, and other important clauses.

3.2.1. Ownership and Transfer of Shares

3.2.1.1.Transfer of Shares to a Third Party

Unless otherwise provided for in the MoA, the Commercial Code does not put restrictions on the transfer of shares among shareholders.[87] However, a shareholder, prior to transferring its share in the company to a third party, shall give the right of first refusal to the remaining shareholders to purchase the offered shares at the price offered to it and under the same conditions.[88] If none of the remaining shareholders make use of their right and offer to purchase the shares within 15(fifteen) days from receipt of a notice, the offering member may accept the offer made to him

[85] David Snow, 'Private Equity: A Brief Overview, An introduction to the fundamentals of an expanding, global industry' Private Equity International Media, P. 2 <https://www.law.du.edu/documents/registrar/adv-assign/Yoost_PrivateEquity%20Seminar_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview_318.pdf> accessed 10 June 2023

[86] BGF, BGF Explains: What is private equity and how does it work , 2022 <https://www.bgf.co.uk/insights/what-is-private-equity/#:~:text=Private%20equity%20is%20a%20form,firms%20also%20do%20minority%20investment.> accessed 10 June 10,2023

[87] Commercial Code Proclamation (n 1) Art 508(2)

[88] ibid Art 508(3)

by the third party.[89] On the other hand, the Commercial Code states that unless a larger majority or unanimity is specified in the MoA, such transfer of shares to a third party shall be approved by members representing at least three-quarters of the capital.[90] This means that even if the remaining shareholders are not willing to purchase the offered shares, the offering shareholder may not dispose of his shares to any person outside the company without getting the approval of shareholders holding ¾ (three-quarters) of the capital.

The situation where there is no shareholder willing to purchase the shares and where the transfer is also not approved by the shareholders having the required capital basically puts the shareholder who is offering to sell his shares (the selling shareholder) in a detrimental position because it can neither dispose of its shares to the remaining shareholders nor to a third party.

To curb the above-mentioned problem faced by shareholders, if the remaining shareholders do not show willingness to buy the offered shares within the specified days or if any portion of the offered shares remain unsold, then the SHA permits the selling shareholder to transfer such shares to the third-party purchaser without observing the requirement of approval by members representing at least three-quarters of the capital provided by the commercial code.[91]

The other issue related to this is the period. The right of refusal period provided under the commercial code is 15(fifteen) days.[92] Deviating from this provision of the commercial code, shareholders will provide for extended dates in their agreements.[93]

3.2.1.2. Mandatory Sale

According to some agreements, a shareholder is assumed to have served a notice to transfer its shares to the remaining shareholders or to the company itself in the event it violates its obligations under the agreement and fails to remedy them within a certain agreed period of time.[94] It's also deemed to have served the transfer notice right before the event occurs where a shareholder (being a company) shall go into mandatory or voluntary liquidation, become insolvent or suffer any similar event, or if an individual shareholder is declared bankrupt, suffers from mental

[89]ibid Art 508(4)

[90]ibid Art 509 (1)

[91]SHA of Company A (with the researcher), 2018, Art 7.3 (e)

[92] Commercial Code Proclamation (n 1) Art 508(4)

[93]SHA of Company A (n 91) Art 7.3 (b); SHA of Company B (with the researcher), Art 8.5

[94]SHA of Company D (with the researcher), Art 14.1

health issues, or dies.[95] Hence, SHAs provide for mandatory sale provisions as a punishment for breach of a shareholder's obligation or to maintain the continuity of the company in the occurrence of a certain event.

Even though the commercial code is silent on the fate of shares of an artificial person shareholder (a company) when it is dissolved, it provides for the fate of an individual shareholder when s/he dies by stating the shares of a deceased shareholder shall be transferred to his/her heirs, subject to contrary provisions in the MoA.[96]

3.2.2. Decision Making

SHAs specify how decisions are made and what is needed to pass resolutions. It also includes matters like quorum requirements and voting thresholds.

3.2.2.1.Majority and Quorum of General Meetings

Neither the matters to be discussed on nor the majority and quorum of ordinary and extraordinary general meetings are the same. This is why there is a need to separate these two meetings. As such, in the case of a PLC, while a decision at an ordinary general meeting requires the presence of shareholder(s) representing more than half of the capital of the company[97]a simple majority of shares represented at the meeting is required by law for decisions to be made.[98]In the event that the required quorum is not obtained at the first meeting, the members shall be called again, and at the second meeting, decisions shall be made by a simple majority of the shares present without taking into account the amount of capital represented. [99]

In the case of an extraordinary general meeting of a PLC, the law requires a unanimous decision of members to change the company's nationality or increase its capital by increasing the par value of its existing shares.[100]However, unless a greater quorum and majority are specified in the MoA, where a company's capital is to be increased using profits or reserve monies that may be allocated to members and an amendment to the MoA requires the consent of members representing three quarters of the capital.[101]

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[95] ibid Art 14.2

[96] Commercial Code Proclamation (n1) Art 511 (1)

[97]ibid Art 525 (1)

[98]ibid Art 525 (3)

[99]ibid Art 525(4)

[100] ibid Art 526(1)

[101] ibid Art. 526(2) & (3)

Art. 526 is silent on the existence of subsequent meetings where there is a lack of quorum at the first meeting. Yet, Art. 527(1) of the Commercial Code cross-referred Art 402 from the section governing S.Cs.

Quorum: Some agreements treat the quorum and majority of both ordinary and extraordinary general meetings as one by referring to them as meetings. In their SHAs, they provide similar majority and quorum requirements for both meetings. One SHA states that a quorum for doing business and the taking of action by the shareholders at any of the shareholders' meetings shall be any number of shareholders holding at least two third (2/3) of the share of the company as of the date of such meeting.[102]

The other issue related to quorum is the lack of quorum at the first meeting. Even though the law doesn't require a quorum to be fulfilled at the second meeting in the case of an ordinary general meeting and allows it to be conducted without regard to the amount of capital represented, some SHAs provide for a quorum in order for the second meeting to be conducted and pass decisions. They also provide for a lesser quorum requirement than provided under Art.525 (1) for ordinary general meetings and Art. 526 for extraordinary general meetings[103]

Majority: As per the indications of the Commercial Code, the decisions that are to be taken by an extraordinary general meeting and which require unanimity are changes in the nationality of the company and an increase in the capital of the company by raising the par value of existing shareholders. An increase in the capital of the company from profits or reserve funds that may be distributed to members and amendments to the MoA may also require unanimity or a greater majority than the one provided in the Commercial Code if it is provided for in the MoA. The rest of the issues may be decided by an ordinary general meeting with the quorum and majority provided for it, i.e., with the representation of members having half of the capital and decision taken by simple majority. Nevertheless, some SHAs provide a greater majority[104]and unanimity[105] for issues to be decided by a simple majority and by the ordinary general meeting, such as the payment of dividends and the appointment, removal, or replacement of auditors.

[102]SHA of Company A(n 91)Art. 3.4. (a).

[103] ibid Art. 3.4. (b) ; SHA of Company E (with the researcher) Arts. 9.1 & 9.2

[104]SHA of Company B (n 91), Art 5.1

[105] SHA of Company A (n 91) Art 3.6. (a); SHA of Company C (with the researcher), Art. 6.1.2

Some SHA leave matters to be decided by an extraordinary general meeting, such as a change in the nationality of the company and an increase in the capital of the company to the ordinary general meeting.[106]

3.2.2.2.Quorum for board meetings

As per the Commercial Code, the quorum provided for the meeting of the board of directors to pass a valid decision is a majority.[107] However, some SHAs provide a greater quorum for conducting and taking decisions at the meeting of the board of directors.[108] They also provide a lesser quorum than a majority for adjourned board meetings due to a lack of quorum at the first meeting.[109]

3.2.3. Management and Board Composition

The appointment, removal, and responsibilities of directors, as well as the composition of the board of directors, could be regulated by SHAs.

3.2.3.1.Involving a Shareholder in the Decisions of the Board of Directors

Shareholders provide in their SHA for a decision not to be taken unless a shareholder who is entitled to appoint a director but failed to do so approves the decision made by the board of directors.[110] As a consequence, these provisions empower shareholders to have a say in a decision to be taken by the meeting of the board of directors.

3.2.3.2.Appointment of Chairperson of the Board of Directors

According to the Commercial Code, the chairperson of the board of directors is elected by the shareholders' meeting. However, where no chairperson has been elected by the shareholders' meeting, the board of directors must appoint a chairperson from among its members.[111] On the contrary, parties in their SHA reserve the right to appoint the chairperson of the board of directors to a certain shareholder.[112]

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[106]SHA of Company E (n103), Arts. 7.1.2& 7.2

[107]Commercial Code Proclamation (n 1) Art. 308(1)

[108]SHA of Company C (n 105) Art. 6.1.2 (b)

[109]SHA of Company A (n 91) Art 4.8; SHA of Company C (105) Art.5.8.4

[110]SHA of Company A (n 91)Art. 6.1.2 (b)

[111] Commercial Code Proclamation (n 1)Art. 300(2)

[112]SHA of Company A (n 91), Art. 4.2 (b); SHA of Company B (n 91)Art. 24.3

3.2.3.3. Giving More Than One Vote for a Single Director

Some SHAs entitle a shareholder to nominate two directors, and if it fails to nominate two and nominates only one director, such a director will have two votes at any board meeting.[113]In addition, some SHAs will also entitle a director nominated by one shareholder to have two votes in case one of the shareholders of the company fails to utilize their right to appoint a director.[114] For instance, if two shareholders of a certain company have the right to nominate one director each, and if one of the shareholders has not exercised its right to nominate a director, then the director to be nominated by the other shareholder will be entitled to have two votes at any board meeting.

3.2.3.4.Quorum Rights

Some SHAs provide that no decision shall be taken by the board of directors unless directors appointed by specific shareholders are present at a meeting.[115] With this, even though the legally required quorum is present, the board of directors may not take any decision if the directors appointed by such shareholders are not present in the meeting.

3.2.3.5. Assigning Board Observer

Even though the commercial code doesn't recognize a board observer, some SHAs provide for the possibility of having a board observer who has the right to be notified of, attend, and speak at all meetings of the directors but is not entitled to be considered when counting quorum for the board meeting and is not eligible to vote on any of the directors' resolutions.[116]

3.2.4. Exit Strategies

The SHA could lay out methods and mechanisms for shareholders to leave the company, such as tag-along rights, drag-along rights, and other arrangements relating to the sale or transfer of shares.

3.2.4.1.Drag-Along and Tag-Along Rights

These rights of shareholders are not regulated in the commercial code; thus, shareholders regulate them in their SHAs.

If a drag-along right is reserved for a shareholder in the SHA, when that shareholder intends to sell or transfer its shares to a third-party buyer, it shall give notice to the other shareholders of such

[113]SHA of Company C (n 105), Art. 5.1.3 (a)

[114] ibid Art.5.1.5 (b)

[115]SHA of Company C (n 105), Art 5.8.3

[116] ibid Art. 5.1.5

intention and a time frame within which the other shareholders shall sell all or a proportion of their shares to the buyer on the same terms and conditions offered to the selling shareholder.[117] In this case, the other shareholder is obliged to sell and is deemed to have accepted the offer of the third-party buyer in respect of all or in *pro rata* terms.[118]Therefore, when the shareholder with drag-along right finds a buyer, he has the right to oblige the other shareholders to sell their shares to the third-party buyer.

On the other hand, tag-along rights require a shareholder intending to sell or transfer its shares to a third-party buyer to notify the shareholders with tag-along rights in advance of the intended sale. The selling shareholder shall not be entitled to sell its shares to such third party unless said third party makes the same offer to acquire the shares of the other shareholders *pro rata* to the selling shareholder.[119] Shareholders with tag-along rights are entitled to sell their shares at their own discretion and on the same terms and conditions offered by the buyer to the selling shareholder. If the buyer is not willing to buy the shares of the other shareholders, then the entire sale will not take place.[120]

3.2.4.2.Put and Call Options

These options are also not governed by the commercial code of Ethiopia. A put option is there to allow a shareholder, by issuing a put notice, to require the company or the other shareholder to acquire or purchase all or a portion of his shares within a certain fixed timeframe agreed upon by them.[121] Where a shareholder issues a put notice, the other shareholder is deemed to have purchased its shares, and the shareholder issuing the notice is deemed to have already sold its shares to the other shareholder.[122] Therefore, put options enable a shareholder to sell all or only a portion of its shares back to the company or the other shareholders at a later date or in the event of certain circumstances. Put options are needed by investors who want to be able to sell their shares early if it doesn't generate a specific amount of revenue by a given date.

On the other hand, a call option is an option where a shareholder, by issuing a call notice, requires the other shareholder to sell him all or a portion of its shares within a certain fixed timeframe

[117]SHA of Company A (n 91)Art. 8.3; SHA of Company E (n 103) Art. 18.1

[118]SHA of Company B (n 93) Art.11

[119]ibid Art.12; SHA of Company E (n 103) Art. 17.1

[120]SHA of Company A (n 91) Art 8.4

[121]SHA of Company B (93) Art.13.1.2

[122] ibid Art. 13.3

agreed upon by them.[123] When the purchasing shareholder issues a call notice, it is deemed that it has already purchased the other shareholder's shares.[124] Thus, call options give shareholders or the company the right to require a shareholder to sell its shares. As opposed to a put option, which gives you the right to sell a stock at a given price and date, a call option is a contract that grants you the right to purchase a stock at a specific price on a specific date.

3.2.4.3.Valuation

Among the rights related to exit rights is a valuation method. SHA can stipulate how the shares of a departing shareholder should be valued, including naming a valuation firm in the SHA. The investor may also specify the value of its shares at the time and the expected estimated value at the time of its departure. This is especially true when a shareholder leaves the management to the other shareholder.[125]

3.2.5. Dispute Resolution

SHAs often contain mechanisms for resolving shareholder disputes, such as arbitration or mediation. This provides an organized framework for conflict resolution. SHAs in Ethiopia also incorporate dispute resolution clauses in case a dispute arises between the shareholders.[126] Since the legal advisors of the investors do not believe in the judicial capacity of Ethiopian courts and because they believe that there is a lack of awareness and jurisprudence in the matter, most dispute settlements are made through arbitration.[127] In addition, the applicable law is mostly made to be the laws of England and Wales[128] and the seat of arbitration will also be outside of Ethiopia.[129]

[123] ibid Art.13.1.1

[124]ibid Art. 13.2

[125]Interview with Beakal Abate (n 84); Interview with Mesfin Tafesse (n 84)

[126]ibid

[127] ibid; SHA of Company B (n 93) Art. 30(2);SHA of Company C (n 105)Art. 22(2); SHA of Company E (n 103) Art. 29

[128]SHA of Company C (n 105) Art. 22.1, SHA of Company D (n 94) Art. 30.1, SHA of Company E (n 103) Art. 28 Interview with Behakal Abate (n 84), Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse (n 84)

[129]SHA of Company B (n 93) Art. 30(4); SHA of Company C (n 105) Art. 22.5; Interview with Mesfin Tafesse (n 84); Interview with Behakal Abate (n 84); Interview with Getu Shiferaw (n 84)

3.2.6. Other Provisions

3.2.6.1.Prevalence(Supremacy) of the SHA

Some of the agreements specifically state that the provisions of the SHA shall prevail in cases of conflict or inconsistency between the agreement and the MoA of the companies.[130]

3.2.6.2.Issuing Preferential Shares

The Commercial Code provides that S.C. may issue preferential shares that give preference over other shares. Priority over profits, a preferred right of subscription for future issues, a priority right over contributions, or the distribution of shares of the surplus upon winding up are some of the special benefits derived from preferential shares.[131] However, the commercial code is silent on the ability of PLCs to issue preferential shares. Even though the commercial code is silent on the existence of preferred shares in PLCs, some SHAs provide for the issuance of preferred shares.[132]

3.2.6.3.Deadlock provisions

This is a provision that is inserted into SHAs to solve disagreements in situations where shareholders cannot reach a decision. If an agreement is needed in order to make a decision and if shareholders fail to reach an agreement, deadlock provisions are kinds of provisions that go to the extent of forcing one shareholder to exit from the company.[133] For instance, the agreement may stipulate that two consecutive meetings be held so as to give shareholders a chance for discussion. If they fail to reach an agreement on these two meetings, then the matter will be referred to a mediator, who will pass a non-binding decision. If they still do not agree with the decision given by the mediator, then they will appoint an adjudicator with mutual agreement, or if they don't agree on who the adjudicator should be, they will assign an appointing authority. The appointed adjudicator will pass a decision on the matter. Finally, the agreement provides a mechanism by which a shareholder who does not agree with the decision given by the adjudicator may exit.[134] The other scenario could be putting in place a mechanism by which one of the shareholders may purchase the shares of the other. If one shareholder is not participating in meetings or if they fail to reach an agreement on matters, each shareholder will give the other party a price at which it

[130]SHA of Company A (n 91) Preamble (i); SHA of Company D (n 94) Art. 19.2; SHA of Company E (n 103) Art. 20.2

[131] Commercial Code Proclamation, (n 1) Art 279(1)

[132]SHA of Company C(n 105) Arts 14 & 16

[133] Interview with Beakal Abate (n 84); Interview with Mesfin Tafesse (n 84)

[134] Interview with Beakal Abate (n 84)

intends to buy the other shareholder's shares. A shareholder who proposes a better price will purchase the other shareholder's shares.[135]

The shareholder who exits shall take the value of its shares in the company; thus, the deadlock provision may extend to the process of valuation of its shares and how it is going to be paid.[136]

3.2.6.4.Lock-in Provisions

These are provisions by which one shareholder prohibits the other shareholder from exiting the company for a certain period of time or as long as the other shareholder remains a shareholder.[137] For instance, they may agree that shareholders are obliged to stay in the company and may not transfer their shares for the next specified years even if they find a buyer.

3.3. The Need for SHA for PLCs in Ethiopia

As shown in the previous chapters, SHA is an agreement defining the rights and obligations of shareholders. These agreements are mainly used to govern detailed relationships between the shareholders and particulars that the commercial code and the MoA of Companies doesn't cover.[138]

Private equity investors sign an agreement and invest in the businesses they find bankable. These investors are not long-term investors; rather, they are short-term investors whose business model is exiting the company they invested in after maximizing their investment. For this reason, the exit has to be as smooth as possible, and they require the signing of SHAs with the remaining shareholders to this effect.[139]Moreover, funders in PE will not fund the intended investment without reviewing the SHA and making sure that a proper exit strategy is agreed upon. Thus, huge brownfield investments will not happen in Ethiopia without SHAs because there will be no funds.[140]In addition, there are terms that are confidential that the parties don't want to make public by incorporating them in the MoA of the company. And these provisions have to be binding at the same time. Thus, the parties will enter into a separate agreement called SHA to govern those

[135] Interview with Mesfin Tafesse (n 84)

[136] Interview with Beakal Abate (n 84)

[137] ibid; Interview with Mesfin Tafesse (n 84); Interview with Getu Shiferaw (n 84); SHA of Company E (103) Art. 15

[138] Interview MesfinTafesse, (n 84)

[139]Interview with Beakal Abate(n 84)

[140]Interview with Getu Shiferaw (n 84)

issues.[141] What is more, most of them govern multi-million-dollar investment agreements, so the issues of the shareholders will be numerous as well. Incorporating all the issues into the MoA will not be practical.[142] Furthermore, the part of the Commercial Code governing PLCs is not as detailed as the part governing S.Cs. There may be various issues that the law doesn't regulate when it comes to PLCs. Therefore, shareholders may want to regulate such instances by concluding a contract beforehand so SHA can fill the gap. Besides, the solution of cross-referencing in the new Commercial Code is not always helpful.

The emergence of venture capital (VC) firms also requires SHA. VC firms invest in young, innovative startups[143] as opposed to PE firms. Entrepreneurs that set up new innovative businesses often need huge capital to grow their businesses, so they conclude SHA with future investors in return for funding. In this context, SHA is a mechanism by which they circumvent some legal provisions. The most common problem is that VC firms contribute capital, but start-up business owners have only ideas. As per Art.17 (1)(c) of the Start-up Businesses Proclamation, one-fourth of its capital shall be held by the entrepreneur, and an idea is not considered a valid contribution according to the Commercial Code. However, at times the VC contributes the entire capital, but the idea contributor is given shares. Hence, the funds supplied by the external investor will be counted towards the start-up owners. Assigning shares for ideas can only be the subject of SHA, but not the MoA.

For the abovementioned reasons, shareholders of a PLC may want to conclude SHAs in order to minimize further disputes and confusion.

[141]Interview with Beakal Abate (n 84); Interview with Getu Shiferaw(n 84); Interview with Mesfin Tafesse (n 84)

[142]Interview with Behakal Abate (n 84); Interview with Mesfin Tafesse (n 84)

[143]William Janeway, Ramana Nanda & Matthew Rhodes-Kropf, 'Venture Capital Booms and Startup Financing' (2021) Harvard Business School Working Paper P2<https://www.hbs.edu/ris/Publication%20Files/21-116_c8365ab5-7cad-4ba3-9e02-ddec0191413f.pdf> accessed on 22 September 2023

Chapter 4

Validity and Enforceability of Provisions of Shareholder Agreements in The Light of the Commercial Code of Ethiopia

This chapter has three sections. The first section deals with the practice of authentication and registration of SHA at the Federal Document Authentication and Registration Service. The second section analyzes the enforceability of provisions of SHAs that are inconsistent with the Commercial Code and the MoA and the last section deals with effects of SHAs on the rights of third parties.

4.1. Authentication and Registration of SHAs in Ethiopia

Authentication and Registration of Documents' Proclamation No. 922/2015 defines a document as any written matter submitted for authentication and registration, including any contract, MoA, and minutes.[144]Powers of attorney and their revocation, and the MoA of business organizations and other associations and their amendments and documents that must be authenticated and registered in accordance with other laws, shall have no legal effect unless they are authenticated and registered.[145] The notary shall authenticate and register other documents where the involved parties so desire.[146] However, before authenticating and registering any document, a notary shall ascertain the legality and morality of its contents,[147]and the right and authority of the person who has signed or is about to sign it.[148]

When it comes to SHAs, officers of DARS that the researcher interviewed claimed that SHAs have never been submitted to DARS for authentication and registration. However, they have two views regarding their authentication and registration. According to Ato Menur, manager of the main branch of DARS in Mexico Square, since SHAs are contracts, they could be registered as long as they don't contravene the mandatory provisions of the Civil Code, Commercial Code, and the company's MoA. He also believes that shareholders may also agree on matters that the commercial code is silent on. However, in order to authenticate and register documents other than the MoA,

[144] Authentication and Registration of Documents' Proclamation , 2015, Art 2(1), Proc. No 922, Neg. Gaz. Year 22, no. 39

[145] ibid Art. 9(1)

[146] ibid Art. 9(2)

[147] ibid Art. 13(1)

[148] ibid Art. 14(1)

the MoA should indicate that those matters incorporated in the SHA will be governed by another document, i.e., the SHA. In other cases, the shareholders may amend the MoA through a minute and incorporate issues into the MoA.[149] Therefore, SHAs may not be authenticated and registered unless the MoA contains a stipulation as to the existence of another document to govern some specific matters. On the other hand, other officials of DARS argue that any agreement pertaining to a company and its shareholders other than the MoA has no legal basis in Ethiopia. In their view, the Authentication and Registration of Documents' Proclamation obliges the notary to ascertain the legality of documents before authenticating and registering them. Since no agreement is recognized under the Commercial Code concerning a business organization and its shareholders other than the MoA, SHAs are illegal.[150] Thus, agreements relating to a company and its shareholders other than MoAs will not be authenticated and registered since they have no legal basis in Ethiopia, which makes them unlawful. Every issue shall be incorporated in the company's MoA, or shareholders may amend the MoA through minutes in order to make the issues part of the MoA.

As mentioned in the previous chapters, the primary objective of SHA is to govern the details of the members' cooperation that the parties are not intending to make public and whose publicity is not required by company or registration law. Most shareholders prefer not to incorporate them in the MoA of the company, and their lawyers advise them to do the same to avoid making the documents public since they contain confidential information.[151] With regards to authenticating and registering the agreements, while some do not get them registered because DARS rejects them[152], some don't because they are not obliged to.[153]

SHAs are not listed in the list of documents listed under Art.9 of the Authentication and Registration of Documents' Proclamation as having no legal effect unless they are authenticated and registered. Therefore, parties are under no obligation to do so, and the agreements have legal effect even though they are not authenticated and registered.

[149] Interview with Menur Mehamed (n 20)

[150]Interview with Abinet Wondimu (n 20); Interview with Damtew Yohannes (n 20)

[151]Interview with Beakal Abate (n 84); Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse (n 84)

[152]Interview with Beakal Abate (n 84); Interview with Mesfin Tafesse (n 84)

[153] Interview with Getu Shiferaw (n 84)

The proclamation included contracts in the definition of documents. According to the proclamation, the notary shall authenticate and register documents if the parties so require, after ascertaining the legality and morality of their contents.

Black's Law Dictionary defines an illegal contract as a promise that is prohibited because the performance, formation, or object of the agreement is against the law.[154] In addition, it defines an immoral contract as one that so flagrantly violates societal norms as to be unenforceable.[155] Having a SHA does not violate any provision of any law, and so long as the agreements do not incorporate promises that are prohibited by law or violate societal norms, they can't be labeled as illegal or immoral. Therefore, DARS should not refuse their authentication and registration on the ground that they are not recognized under the Commercial Code and should authenticate and register SHAs if parties so require, after checking the legality and morality of their content.

4.2. Enforceability of provisions of SHA

The Ethiopian Commercial Code, together with other pertinent laws and regulations, primarily governs the legal framework for PLCs in Ethiopia. These laws set forth the general guidelines and requirements for their formation, management, and operation.

The Commercial Code and the MoA are key legal documents in Ethiopia that govern the formation, operation, management, and dissolution of a business organization. These documents serve as the cornerstone for the legal structure of a company.

When it comes to SHAs, all the judges and the lawyers that the researcher interviewed agreed that the Ethiopian law doesn't prohibit shareholders from having SHA.

As mentioned in the previous chapters, SHAs are legally enforceable contracts between parties who have freely agreed to them. On the other hand, the enforceability of certain provisions in SHA that are inconsistent with the Commercial Code requirements or a company's MoA can depend on the jurisdiction.

The researcher could not find any court decisions or arbitral awards involving SHAs as sources of rights and obligations of shareholders in Ethiopia. Therefore, in this section, the researcher assessed the views of practicing lawyers from selected law firms in Ethiopia and judges of different levels of federal courts on the enforceability of provisions of SHAs that are inconsistent with

[154]Henry Campbell Black, Black's law dictionary (Bryan A. Garneed, 8th edn, Thomson/West, St. Paul 2004)

[155] ibid

provisions of the Commercial Code and the MoA of companies. The researcher also reflected her view on the issues raised.

4.2.1. Commercial Code Vs SHA

4.2.1.1. The SHA that expressly derogate from the mandatory provisions of the Commercial Code

All the interviewees, judges, and lawyers have a belief that provisions of SHAs that are inconsistent with mandatory provisions of the Commercial Code shall not be valid and enforceable.

Even though parties have freedom of contract and the terms of a validly formed contract are enforceable against the parties as if they were law,[156] parties shall determine the content of their contract pursuant to the mandatory provisions of the law.[157] A good example of a mandatory provision of the Commercial Code could be Art. 526. It states that changes in the nationality of the company, an increase in the capital of the company, and an amendment to the MoA are matters to be decided by an extraordinary general meeting of shareholders. However, for instance, one of the SHAs reserves the power to decide on the change in the nationality of the company and the increase in the capital of the company to the ordinary general meeting.[158] In addition to Art.526 being mandatory, Art. 394(5) states that ordinary general meetings have the power to decide on matters, with the exception of those matters specifically reserved to extraordinary general meetings under the code. This makes it clear that the ordinary general meeting may not decide on matters that are specifically reserved for the extraordinary general meeting. Thus, any contractual stipulation conferring the powers of an extraordinary meeting on an ordinary general meeting is invalid and hence unenforceable.

a. Quorum right for board meeting

There are three views in relation to quorum rights. The first group argues that if quorum rights are reserved for a certain shareholder, they are setting a higher threshold, and if they are reserving quorum rights for decisions on certain matters, then that party is saying the matter is a consent matter of the shareholder or director that is assigned by some shareholder. In both cases, they are setting a higher threshold than that provided by the law, which should be valid and binding as long

[156]Civil Code of the Empire of Ethiopia Proclamation (n 8) Art. 1731(1)

[157]Ibid Art.1731(2)

[158] SHA of Company E (n 103) Art.7.1.2 & Art.7.2

as the parties agree and is not expressly prohibited by the law because it is control at the end of the day and has a legitimate business purpose.[159]The second view is that quorum rights increase the requirements provided in the code. However, since quorum rights are an issue of management, they may be enforceable if they are incorporated into the MoA or recorded in a minute. But provisions governing quorum rights in SHA should not be enforceable.[160] The third group argues that the members of the board of directors are there to serve the interests of all the shareholders equally, not the interests of individual shareholders.[161] In addition, agreements implying that no quorum exists unless a director nominated by a certain shareholder is present will not be enforceable because no decision can be made without that person, which is detrimental to the company.[162]Furthermore, what is needed to pass a decision is the required quorum, and the board acts as one.[163]Therefore, quorum rights should not be enforceable.

Quorum right in meetings implies that the Board of Directors or the general meeting may not pass any decision regardless of the presence of the required quorum for the simple reason that a single director or shareholder is not present. In other words, the directors/shareholders present at the meeting are inadequate to pass a decision only because one of the directors/shareholders that constitute the quorum is not a certain shareholder or the director who is appointed by a certain shareholder enjoying the quorum right. The quorum for the board meeting under Art.308 (1) of the Commercial Code is the majority of directors. This provision seems to determine the quorum entirely by the number of directors present at a board meeting, with no consideration as to who nominated them. In addition, there is no capital requirement for determining quorum and majority

[159]Interview with Beakal Abate (n 84); Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse (n 84)

[160] Interview with Meka Nesru, Judge at 2nd Commercial Bench, Federal First Instance Court, Commercial and Investment Bench (6 June 2023)

[161]Interview with Ajema Gadissa Judge at 1st Commercial and Investment Bench , Federal High Court, Lideta Civil Bench, (16 June 2023); Interview with Ashenafi Workneh Judge at 1st Commercial and Investment Bench & 5th Commercial Bench , Federal High Court, Lideta Civil Bench, (16 June 2023); Interview with Endale Tadesse, Judge at 1st Commercial and Investment Bench & 3rd and 4th Commercial Bench, Federal High Court, Lideta Civil Bench, (16 June 2023);; Interview with Gerawork Yitbarek, Judge at 3rd Commercial Bench, Federal First Instance Court, Commercial and Investment Bench, (15 June 2023)

[162]Interview Shemsu Sirgaga, Judge at 2nd Civil Appellate Bench, Federal Supreme Court (30 June 2023), Interview with Yohannes Nuguse at 2nd Civil Appellate Bench, Federal Supreme Court (30 June 2023)

[163] Interview with Ashenafi Lemmecha, Judge at 4nd Commercial Bench, Federal First Instance Court, Commercial and Investment Bench (7 June 2023)

at board meetings. Furthermore, as argued by some of the interviewees and as can be clearly seen from Art.315 of the Commercial Code, the role of the Board of Directors is to serve the company and all the shareholders rather than a single shareholder.

Coming to quorum right in general meetings, the quorum for an ordinary general meeting required by Art. 525(1) of the Commercial Code is the presence of a shareholder(s) representing more than half of the capital of the company. Where the required quorum is not obtained at the first meeting, the code requires no quorum. In addition, for an extraordinary general meeting, Art. 526 require the presence of all shareholders to change the company's nationality and to increase the company's capital by increasing the par value of its existing shares. And it requires the presence of at least three-quarters of the capital to increase its capital using profits or reserve monies that may be allocated to members and to amend the MoA. Both provisions determine quorum based on capital and not the identity of a shareholder. Quorum right in general meetings can only exist where a shareholder is a major shareholder; quorum will not be fulfilled without the presence of the capital represented by him. In other cases, there should not be quorum rights.
For the above-mentioned reasons, provisions of SHAs granting quorum rights should be invalid and not enforceable.

b. Giving more than one vote for a board director appointed by certain shareholder

There are two views regarding giving more than one vote for a single director. The first is that it is not legally prohibited for a member of the board to have more than one vote as there is no one-share, one-vote rule as in the case of shareholders' meetings, thus, it should be binding and enforceable.[164]On the contrary, the prevailing and, in the researcher's opinion, the correct view is that a member of the board of directors may not have more than one vote. The interviewees provided three reasons to support their arguments. First, a board meeting is not a meeting where director votes based on shareholding, like a shareholders' meeting.[165] Second, Art. 308(1) of the Commercial Code requires a majority vote to pass a decision in board meetings, so it can be inferred that it is referring to numbers only, and the law has no intention to give one director a greater vote than the other directors[166] and third, members of the board are there to serve every

[164]Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse, (n 84)

[165] Interview with Behakal Abate (n 84)

[166] Interview with Meka Nesru (n 160), Interview with Shemsu Sirgsga (n 162); Interview with Yohannes Nuguse(n 162)

shareholder equally, not the interests of individual shareholders.[167]In addition, Art. 298(2) of the Commercial Code vest the power to appoint directors at the general meeting. As per Art 525 (3) and (4) decisions are taken by simple majority. Hence the origin of the problem is allowing a shareholder to appoint "his" director to protect his interests as opposed to the law. If all directors are appointed by all shareholders together, the idea of a director exercising multiple voting rights for the benefit of his appointing shareholder doesn't arise. Therefore, giving more than one vote to a director appointed by a certain shareholder is not legal.

c. One shareholder appointing the chairperson of the Board of Directors

There are two views in relation to a single shareholder appointing the chairperson of the Board of Directors. The first group argues that contractual provisions allowing a shareholder to appoint the chairperson of the board are not prohibited by law. So these provisions are legal and should be enforceable because they are a matter of control.[168] On the other hand, others argue that since members of a board are there to manage everyone equally and not to serve the interests of individual shareholders; contractual provisions allowing an individual shareholder to appoint the chairperson are not justifiable.[169] In addition, the code's provision about the appointment of a board chair is mandatory since either the shareholders meeting or the board itself shall appoint the chairperson. Therefore, parties are not allowed to derogate from this provision. [170]

Art. 300 (2) of the Commercial Code gives the power to elect the chairperson of the Board of Directors to the shareholders' meeting, however, where the shareholders' meeting fails to do so, the Board of Directors must appoint a chairperson from among its members. Since electing the chairperson of the board is the power of the shareholders' meeting, the rest of the shareholders may vote in favor of a certain nominee, which results in the director nominated by that shareholder being the chairperson. However, the general meeting may not delegate this power in advance. If the general meeting neither appoints nor delegates its power, then the Board of Directors is the

[167] Interview with Ajema Gadissa (n 161); Interview with Ashenafi Lemmecha (n 163); Interview with Ashenafi Workneh (n 161); Interview with Endale Tadesse (n 161); Interview with Gerawork Yitbarek (n 161)

[168]Interview with Ajema Gadissa (n 161); Interview with Ashenafi Workneh (n 161);Interview with Behakal Abate (n 84); Interview with Endale Tadesse (n 161); Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse (n 84)

[169] Interview with Gerawork Yitbarek (n 161) ; Interview with Meka Nesru (n 160)

[170]Interview with Ashenafi Lemmecha (n 163); Interview with Shemsu Sirgaga (n 162); Interview with Yohannes Nuguse, (n 162)

appropriate organ to elect the chairperson among its members. Therefore, provisions of a SHA that in advance delegate the power of the shareholders' meeting to elect the chairperson of the Board of Directors shall be invalid and unenforceable.

Let's look at two things related to this sub-topic. The first is the validity of a provision that entitles a shareholder to appoint a certain number of directors. As tried to explain in the above sub-topic, directors should be elected by the general meeting by simple majority. That means all directors are appointed by all shareholders together. Therefore, there is no legal way that an individual shareholder may have the power to appoint some directors. The other issue is a shareholder reserving a veto right over the appointment of the general manager. According to Art.514 of the Commercial Code, a general manager shall be appointed by the general meeting, or where there is a board of directors, the manager shall be appointed by the board. This means an individual shareholder may not have veto power over the appointment of the GM. Therefore, any provision of the SHA that confers such a right on a particular shareholder should be invalid and, hence, unenforceable.

4.2.1.2. The SHA is in contradiction to the non-mandatory provisions of the Commercial Code;

All interviewees, judges, and lawyers are of the opinion that shareholders may derogate from the permissive provisions of the Commercial Code. However, they have different opinions about which provisions are permissive and which are mandatory. A good example could be provisions related to quorum and majority.

The interviewees reflected four different views regarding raising and lowering the majority and quorum requirements provided in the Commercial Code to pass decisions. The first view is that the legislator's intention in providing quorum and majority is to enable businesses to have democratic environment in relation to decision-making and management. Therefore, provisions of the code relating to majority and quorum are mandatory, and both raising and lowering the legally required quorum and majority to make a decision on meetings would be unacceptable and hence unenforceable.[171]The second view reflected is that it is better not to vary the quorum and majority requirements of the Commercial Code, as it provides for a standard the legislator considered sufficient for the smooth running of businesses. However, if parties intend to change it, one should look into how the provisions are drafted. If it has indications that it is a minimum requirement,

[171] Interview with Shemsu Sirgaga (n 162); Interview with Yohannes Nuguse (n 162)

such as “not less than” or “at least”, parties can raise the requirements provided therein but not lower them. If the provisions have no such indication, then parties can neither raise nor lower the quorum and majority requirements of the code.[172] The third view considers most of the provisions of the Commercial Code as having a gap-filling role. So the legislature provided provisions for quorum and majority, keeping in mind how the shareholders would have agreed. For this reason, such provisions of the code are not mandatory and will not be applicable if there is a contract between shareholders of a company. Thus, shareholders can lower or raise the requirements provided in the code to make a decision.[173]The last and prevailing view is that the Commercial Code provides for minimum standards as to quorum and majority. Shareholders can raise the bar to make the decision-making process more stringent, but they cannot lower it.[174]

Art. 374(3) of the commercial code explicitly prohibit variation by the MoA from the determined quorum and majority. In other words, in the case of S.Cs, parties may neither lower the size of the quorum and majority to ease the decision-making process nor raise the bar to make the decision-making process stringent, and any contractual provisions having these effects are invalid and hence unenforceable. However, we cannot find similar provision in the part of the Commercial Code governing PLCs. This provision governing S.Cs. is also not cross-referred. Therefore, it can be argued that the quorum and majority standards provided for PLC by the commercial code are minimum standards, and parties can raise the standard quorum and majority; however, they cannot lower it.

The thing that should be taken into consideration in raising the quorum and majority requirements is a case where shareholders would not be able to host the meeting due to a lack of quorum or pass a decision because of lack of the required number of votes. This makes it hard for shareholders to easily pass decisions, which seriously hampers the PLC’s capacity to do business. Thus, if shareholders are to raise the quorum and majority standards provided in the law, then they should adopt clear and effective deadlock provisions that help curb the problem that comes with it.

[172] Interview with Ashenafi Workneh (n 161); Interview with Endale Tadesse (n 161)

[173] Interview with Getu Shiferaw (n 84)

[174] Interview with Ajema Gadissa(n 161); Interview with Ashenafi Lemmecha(n 163); Interview with Gerawork Yitbarek(n 161); Interview with Behakal Abate (n 84); Interview with Mesfin Tafesse(n 84); Interview with Meka Nesru (n 160)

With regards to the argument that says one should look into the drafting of the provisions, the provisions of S.C. governing quorum and majority also use the phrases "at least"[175] and "not less than".[176] This does not mean parties can change the size of the quorum and majority as a result of Art.374 (3) explicitly prohibiting doing so.

Therefore, the researcher agrees with the view that considers the quorum and majority provided under the Commercial Code as a minimum standard in the case of PLCs. However, since the probability of the occurrence of deadlock increases with the increase in quorum and majority requirements, shareholders should provide for a clear and effective deadlock provision.

4.2.1.3. The provisions of the SHA contain possibilities not mentioned in the Commercial Code

These are cases where the commercial code is silent. The interviewees, judges and lawyers, have two views in this regard. The majority of the interviewees believe that SHAs are contractual agreements, and parties have the right to agree in whatever way they want as long as the Commercial Code doesn't put a stipulation as to the prohibition of agreements that derogate from a provision of the code.[177] In other words, if the Commercial Code is silent, i.e., if there is no explicit prohibition or permission, the agreement between the shareholders should be given value. Therefore, SHAs governing issues that are not governed by the commercial code should be enforced. The other group argues that just because the Commercial Code is silent doesn't mean parties are free to contract on those issues. They have to be entertained on a case-by-case basis.[178]

A good example to illustrate this point could be drag-along and tag-along rights and put and call options, which are common in SHAs. Regarding these rights, there are two views among the interviewees that are of the opinion that possibilities that are not mentioned in the Commercial Code are not always considered permitted. Among the four interviewees, two of them believed that there is no law that prohibits shareholders from concluding a contract on the issues, so the

[175] Commercial Code Proclamation (n 1) Art. 398(1)

[176] ibid Arts.402(1), 402(4)(a) & (b)

[177] Interview with Ashenafi Lemmecha (n 163); Interview with Behakal Abate (n 84); Interview with Getu Shiferaw(n 84); Interview with Mesfin Tafesse; (n 84); Interview with Gerawork Yitbarek (n 161); Interview with Shemsu Sirgaga (n 162), Interview with Yohannes Nuguse (n 162)

[178] Interview with Ajema Gadissa (n 161); Interview with Endale Tadesse (n 161); Interview with Ashenafi Workneh (n 161); Interview with Meka Nesru (n 160)

contractual provisions governing them should be enforceable.[179] While the other two argued that the commercial code is not silent on the issues. The Commercial Code has a provision that governs restrictions on share transfers among shareholders and to third parties. The only restriction the code stipulates with respect to the transfer of shares to third parties is the right of first refusal. Any contractual provision providing for restrictions on share transfers other than the right of first refusal is illegal and hence, unenforceable.[180] One of the interviewees also added that a contractual provision that is beneficial to only one of the parties should not be enforceable.[181]

First, Art. 508(2) of the Commercial Code do not impose a statutory restriction on share transfers among members. However, members may restrict the transfer of shares among themselves in the MoA. The reason this is usually done is to maintain the balance of control between members.[182]On the other hand, since the identity of a member in a PLC is an important consideration for other members as well, the right to membership cannot be transferred as the member wishes.[183] As the identity of a member is of paramount importance, the code provides for the right to first refusal under Art.508 (3) to prevent members from freely transferring their share to a third party. Thus, it can be concluded that the law provided the right to first refusal to forbid third parties from joining the company without the consent of the other shareholders and not to prevent shareholders from concluding a contract pertaining to the disposition of their share.

Second, under Ethiopian law, a contract cannot be invalidated for the mere fact that one party benefits significantly from its provisions.[184] They may be invalidated where the consent of the other person was obtained by taking advantage of his want, simplicity of mind, senility, or manifest business inexperience.[185] This should not be an issue with regards to SHAs because they are signed after thorough discussion and bargaining between the parties and expert guidance from their legal advisors.

Third, according to Ethiopian property law, ownership of a property may be transferred through an agreement made between parties.[186] Since a share is property, a party may relinquish ownership

[179] Interview with Endale Tadesse (n 161); Interview with Ashenafi Workneh (n 161)

[180] Interview with Ajema Gadissa (n 161); Interview with Meka Nesru (n 160),

[181] Interview with Ajema Gadissa (n 157)

[182]Fekadu Petros (Assistant Professor), *Ethiopian Company Law* (3rded, Far East Trading PLC, 2014), 297

[183]ibid 296

[184]Civil Code of the Empire of Ethiopia Proclamation (n 8) Art.1710 (1)

[185] ibid Art.1710(2)

[186] ibid Art.1184

over his shares through an agreement such as SHA. In addition, a call option is more or less similar to a promise of sale provided under Art.1410 (1) of the Commercial Code.

Lastly, parties have a right to determine the contents of a contract as long as it doesn't contradict the mandatory provisions of the law[187] and subject to restrictions and prohibitions provided by law.[188] The law also states that the terms of a validly formed contract are enforceable against the parties as if they were law.[189] Therefore, as long as there is no mandatory provision or prohibition relating to clauses of SHAs governing matters that are not contained in the commercial code, including drag-along and tag-along rights and put and call options, shall be legal and hence enforceable, provided that they have legitimate business interests to protect.

The other cases are matters that are allowed for S.Cs and the code is silent on PLCs. For instance, the code allows S.Cs to issue preferential shares, but it is silent on the ability of PLCs to issue these shares. One group of the interviewees believes that the Commercial Code is silent regarding the matter and does not expressly prohibit PLCs from issuing preferential shares, thus, it's legal for them to do so.[190] On the other hand, the other group argues that if something is permitted for S.Cs. and it's silent in the provisions governing PLCs, interpreting it as if it's allowed would be an extended interpretation; it is safe to say it is excluded by inference and assume that the legislator intentionally excluded it.[191] Thus, PLCs are not allowed to issue preferential shares.

The Commercial Code does not only fail to cross-refer provisions governing classes of shares, but Art. 513(3) cross-refer Arts.296, 297, 298 and 300 and the following articles from the provisions governing S.Cs and skips Art.299 which provides for representation of different classes of shares in the board of directors. Hence, it would be safe to conclude that any contractual stipulations enabling PLCs to issue preferential shares in PLCs are contrary to the legislator's intention.

[187] ibid Art. 1731(2)

[188] ibid Art. 1711

[189] ibid Art. 1731(1)

[190]Interview with Ashenafi Workneh (n 161); Interview with Getu Shiferaw (n 84); Interview with EndaleTadesse (n 161), Interview with Mesfin Tafesse (n 84), Interview with Yohannes Nuguse (n 162); Interview with Shemsu Sirgaga (n 162)

[191]Interview with Ajema Gadissa (n 161); Interview with Ashenafi Lemmecha (n 163); Interview with Behakal Abate (n 84); Interview with Gerawork Yitbarek (n 161); Interview with Meka Nesru (n 160)

4.2.2. MoA Vs SHA

4.2.2.1. The SHA is in contradiction to the provisions of the MoA of a company

As mentioned in the previous chapter, out of five SHAs that the researcher examined, three SHAs provide for the prevalence of their SHA in cases of conflict or inconsistency between the SHA and the MoA. There are two views regarding the prevalence and enforceability of SHAs whose provisions are in contradiction with the MoA. The first view holds that both SHA and MoA are contracts between shareholders. SHAs are specifically made to govern the relationships among shareholders; if their provisions contradict each other, the SHA will override the MoA.[192] The other, and prevailing, view is that in case of contradiction between the provisions of the SHA and the provisions of the MoA, the latter should prevail.[193]

The Commercial Code expressly provides that a business organization is established through MoA.[194] In addition, the commercial code defines MoA as a document used to establish a business organization.[195] What's more, the formation of a business organization, with the exception of a joint venture, has no effect unless it is established by a memorandum of association.[196]From these provisions of the Commercial Code, it is clear that the MoA is not just a contract among the shareholders; it is a contract that establishes the business organization itself. The existence of a company is dependent on its MoA. Thus, any contractual provisions that contradict the provisions of the MoA should not be valid and enforceable, even if the SHA is made between all shareholders of a company and the company itself.

4.2.2.2. The provisions of the SHA containing possibilities not mentioned in the MoA

The business purpose of the company, the capital of the company, the number and powers of managers and directors (if any), their number and powers, and other details as specified under Article 500 of the commercial code should only be governed by the MoA. All interviewees, judges, and lawyers agreed that shareholders are allowed to conclude a SHA to govern matters other than

[192] Interview with Getu Shiferaw (n 84); Interview with Ashenafi Workneh (n 161)

[193] Interview with Behaka Abate (n 84); Interview with Mesfin Tafesse(n 84); Interview with Shemsu Sirgaga (n 162); Interview with Yohannes Nuguse (n 162), Interview with Ashenafi Lemmecha (n 163); Interview with Endale Tadesse(n 161); Interview with Ajema Gadissa (n 161); Interview with Gerawork Yitbarek (n 161); Interview with Meka Nesru (n 160)

[194] Commercial Code Proclamation (n 1) Art.172 (1)

[195]ibid Art.173(1)

[196]ibid Art.177 (1)

the specified ones. However, a question arises where shareholders want to vary the provisions of the Commercial Code where it allows parties to agree otherwise in their MoA and the MoA is silent. For instance, Art.308 (1) states that decisions of the board of directors shall be taken by the majority vote of directors unless a greater vote is required by the MoA. In addition, the same sub-article states that the chairperson of the board of directors shall have a casting vote if there is no contrary provision in the MoA. Another example could be Art. 509(1), which states the transfer of shares outside the company shall be approved by members representing at least three-quarters of the capital unless the MoA provides for a larger majority. The last provision that can be raised as an example is Art. 511(1) which says the share of a deceased member shall devolve upon his heirs unless the MoA provides otherwise.

These are some examples of the provisions of the Commercial Code that allow parties to deviate from the provisions of the code through their MoA. Now the question is: can shareholders skip governing these matters in the MoA and regulate them on their SHA? Or do the provisions allow the parties to change them only through the MoA? The interviewees reflected two views on the matter. Some believed that the reason behind incorporating matters in the MoA is to protect third parties, and third parties have no interest in the abovementioned matters.[197] In addition, as long as the agreement does not violate the law, it is valid because it's a contract.[198] Hence, even if the Commercial Code seemed to allow deviation through the MoA, SHAs regulating those matters should still be enforceable even though the MoA is Silent. On the other hand, most of the interviewees argue that if the Commercial Code allows deviation through the MoA, no other means of deviating from these provisions is possible. Where the MoA is silent on those issues, one should refer back to the provisions of the Commercial Code, even if there is another agreement regulating the matter.[199]

4.3. Effects of SHAs on Rights of Third Parties

As per Art 1675 of the Civil Code **"**a contract is an agreement whereby two or more persons as between themselves create, vary or extinguish obligations of a proprietary nature". The expression

[197] Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafesse (n 84)

[198] Interview with Ashenafi Lemmecha (n 163); Interview with Getu Shiferaw (n 84); Interview with Mesfin Tafese (n 84)

[199]Interview with Ajema Gadissa(n 161);Interview with Ashenafi Workneh (n 161); Interview with Behakal Abate (n 84);Interview with Endale Tadesse (n 161); Interview with Gerawork Yitbarek (n 161); Interview with Meka Nesru (n 160); Interview with Shemsu Sirgaga (n 162); Interview with Yohannes Nuguse (n 162)

"as between themselves" in this article suggests that a contract has legal force solely between the parties to it. The Civil Code also contains a provision that reflects the principle of privity of contracts and freedom of contracts.[200]It states that the terms of a validly formed contract are enforceable against the parties as if they were law, and they shall be determined by the parties subject to the mandatory provisions of the law. Therefore, contracts including SHAs should not affect third parties and should only be enforceable against the parties involved. Moreover, the Civil Code also has depict the principle of relative effect of contract[201] i.e. contracts shall produce effect only as between the contracting parties. This article does, however, highlight that there may be instances in which a contract including SHA may impact third parties. These exceptions are mentioned from Article 1953 to Article 2000 of the Civil Code.

[200]Civil Code of the Empire of Ethiopia Proclamation (n 8) Art.1731
[201]Civil Code of the Empire of Ethiopia Proclamation (n 8) Art.1952

Chapter Five

Conclusion and Recommendation

5.1. Conclusion

A PLC, like any business organization, is created with the intention of engaging in an economic activity and making profit out of the activity. Since establishing a company requires both financial and human resources, business owners call on private investors to invest in their business.

As disagreements are inevitable when doing business and as the Commercial Code and the MoA may not be sufficient to address and solve them, and for different other reasons, shareholders put in place SHA to control the operation of the business and regulate the relationship amongst shareholders. SHAs mostly regulate rights other than those that are inherent to shareholders. As these agreements are separate from the MoA, they are not required to be entered into the commercial registrar, and they are also not authenticated and registered by the DARS. Therefore, these agreements hold private information and are kept confidential. For this reason, shareholders tend to incorporate provisions that are inconsistent with the Commercial Code and the MoA of the companies. As the commercial code is silent even on the existence of these agreements, their legal basis, subject matters regulated by the agreements, and the extent to which parties' freedom of contract is honored are questioned.

In the first research question, it is clear that a SHA is a contract inasmuch as it adheres to the requirements stipulated by the Civil Code, i.e., the parties have the capacity to enter into a contract and give their consent to be bound by the terms of the contract; the object of a contract is sufficiently defined, possible, lawful, and moral; the contract is made in the form prescribed by law, if any; and finally, the content of the contract is determined pursuant to the mandatory provisions of the law.

In the second research question, subject matters that are regulated by SHAs in Ethiopia include restrictions on share transfer such as the right of first refusal and mandatory sale, decision making such as majority and quorum requirements, conduct of business and management such as involving a shareholder in board decisions, appointment of the chairperson of the board, giving multiple votes for a single director and quorum rights, exit strategies such as tag-along and drag-along rights, put and call options and valuation, and other clauses such as dispute resolution, the supremacy of the SHA, and many more.

In the third research question, even though all the judges and lawyers that the researcher interviewed agreed that SHAs are contracts and are regulated by the law of contracts, their

enforceability is still an issue. The first question arises when provisions of the SHA are inconsistent with the Commercial Code. The cases that may arise from this aspect are that the SHA expressly derogates the mandatory provisions of the Commercial Code, the SHA is in contradiction to the non-mandatory provisions of the Commercial Code, and the provisions of the SHA contain possibilities not mentioned in the Commercial Code. In the first and second cases, all the judges and lawyers that the researcher interviewed believe that provisions of SHAs that are in contradiction with the mandatory provisions of the Commercial Code should be illegal and hence unenforceable and that SHAs should be allowed to derogate from the non-mandatory provisions of the Commercial Code. However, there is no common understanding as to which provisions are mandatory and which are not, and their opinions differ accordingly. The interviewees do not have shared opinions regarding the third case. Most interviewees believe that SHAs are contracts, so parties have the right to agree as long as the Commercial Code doesn't prohibit agreements that derogate from it. If the Code is silent, the parties' freedom of contract should be respected, and SHAs governing issues not regulated by the code should be enforced. Others argue that the Commercial Code's silence doesn't guarantee parties freedom of contract on the issues, as they must be considered on a case-by-case basis. Therefore, cases will not be decided consistently in this regard.

The other scenario is where some provisions of SHA are inconsistent with the MoA of the company. The cases that might result from this aspect are that the SHA is in contradiction to the provisions of the MoA, and the provisions of the SHA contain possibilities not mentioned in the MoA. Regarding the first case, while some believe that the SHA shall take precedence over the MoA since SHAs are contracts specifically made to regulate the relationship among shareholders, the majority of the interviewees are of the opinion that the MoA should prevail in cases where there is a conflict between the provisions of the SHA and the MoA. With regards to the second case, while all the interviewees are of the opinion that contractual agreements regulating matters that are not mentioned in the MoA should be legal and enforceable, they have different opinions where the Commercial Code allows parties to agree otherwise in their MoA. While some hold the opinion that provisions of SHAs should be enforceable even if the Commercial Code allows deviation through the MoA and the MoA is silent, others believe that if the Commercial Code allows deviation through the MoA, there are no other ways to deviate from these provisions.

Therefore, due to the inconsistent perspectives judges and other legal professionals have with respect to provisions of SHAs that are inconsistent with mandatory provisions of the commercial code or the MoA, they could face challenges in enforceability.

5.2. Recommendations

- The concerned body has to organize awareness creation platforms to make the mandatory provisions of the Commercial Code that cannot be derogated by SHAs clear so that there will be a common understanding among all legal professionals.
- Awareness should be created as to the status of SHAs in relation to the Commercial Code and MoA of companies in order to avoid inconsistencies in enforcement and make them predictable.
- Ethiopian judges must be trained on the issue in order to make investors and their legal advisors trust our legal system because it minimizes the outflow of cases. This in turn minimizes costs incurred by investors in order to settle disputes abroad. In addition, this creates revenue for the government in terms of court fees and creates job opportunities in Ethiopia.

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Interview Questions

Interview Questions for Judges

1. Have you ever encountered shareholders agreements being submitted to the court as sources of rights and obligations?
2. If there was any, what was the dispute about? Was it because the SHA was contradictory with the law? Is it permitted for shareholders to have a separate agreement from the MoA of the company?
3. What is the legal basis for shareholders' agreements in PLCs in Ethiopia?
4. Which provisions of the commercial code contracting parties often change in their SHAs?
5. Which provisions of the Commercial Code are mandatory? Are the rest of the provisions gap-filling or setting minimum requirements?

6. Are matters the commercial law is silent permitted or prohibited? If they are permitted should the shareholders regulate the matters on the MoA or can they also govern them by shareholders' agreements?
7. How would provisions of the Shareholders' agreement be enforced if:
    - Where they are inconsistent with the commercial code and the company's MoA?
    - Where the commercial code is silent (and not governed by their MoA)?
    - Matters that parties are allowed to agree otherwise in their MoA but the MoA is also silent and governed by the shareholders' agreement?
    - Matters specifically governed under Share Company but not under PLC (such as preferred shares)?

Interview Questions for Lawyers

1. What is the legal basis for shareholders' agreement in Ethiopia?
2. What kinds of companies are likely to enter into shareholders' agreement?
3. What issues are addressed by shareholders' agreement in Ethiopia?
4. Do Document Authentication and Registration Service authenticate these documents?
5. Have you ever encountered court or arbitration cases involving shareholders' agreements? Are they enforceable in Ethiopia?
    - If they are inconsistent with the commercial code?
    - If they are inconsistent with the MoA of the company?
    - If the commercial code or the company's MoA is silent of the matters the SHA governs?
    - Matters specifically governed under Share Company but not under PLC, such as issuing preferred shares

Interview Questions for Managers of DARS

1. Have you ever encountered shareholders agreements being submitted for authentication and registration?
2. Do you authenticate and register them?