

ADDIS ABABA UNIVERSITY
COLLEGE OF LAW AND GOVERNANCE STUDIES
SCHOOL OF LAW
GRADUATE PROGRAM



Masters of Laws (LL.M) in Business Law
Examining the Legal and Practical Dimensions of Classes of
Company Shares in Ethiopia

A Thesis Submitted in Partial Fulfillment of the Requirements
for the Award of Masters of Laws (LL.M) in Business Law at
School of Law, College of Law and Governance Studies, Addis
Ababa University

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May, 2021, Addis Ababa, Ethiopia

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May, 2021

Declaration

I, **Yeshe Zewdie**, hereby declare that the thesis titled ‘Examining the Legal and Practical Dimensions of Classes of Company Shares in Ethiopia’ is my original work and that it has not been submitted for any degree or examination in any other university and all sources used in this paper are duly acknowledged.

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Signature.....

Date.....

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Acknowledgment

First, I thank the Almighty God who gave me the strength to complete this paper.

My deepest gratitude goes to my Advisor Zekarias Kenea (Associate Professor) for his invaluable guidance and support starting from framing of the title up to the completion of this paper. This paper would not have been completed in time and will not have the substance it has now without the support I got from my advisor. God bless you to the maximum, Professor.

Next, I would like to thank all the interviewees who sacrificed their time and cooperate to give the relevant data for this paper. My special thanks to Mr. Tsegaw, Information and Technology Directorate Director, Ministry of Trade and Industry for providing me the relevant information.

I am so much thankful to my colleagues Abraham Rega, Almi Desta and Animw Demissie for their intellectual, moral and material support starting from the selection of title up to the completion of this paper.

Lastly, I would like to thank my friends and families for their moral and material support.

Abstract

Business friendly environment is crucial to attract investment in countries. The legal environment is one of the determinants and allowing companies raise their capital by issuing different classes of company shares with a view to attract investment and widen the capital market is one way of creating favorable environment for business. As a result, different countries through a legislative framework permit companies to issue variety of classes of shares. Ethiopia is not an exception to this and hence the commercial code recognizes classes of company shares. However, classes of shares in general and preference share in particular are not used in practice. This research tried to analyze the laws governing classes of company shares in Ethiopia. An attempt is also made to investigate why classes of company shares are not practically issued in Ethiopia. To this end, the researcher used qualitative data collection and analysis methodology. The Commercial Code, the Banking and Insurance Business Proclamations are consulted; the researcher has also interviewed officials and experts at MoTI, DARA, EIC, commercial law experts in law firms and share companies. The finding of this research relieve the Commercial Code has limitation in expressly recognizing variety of shares. Even if the code recognizes preference share that the provisions lack clarity and flexibility. The draft Commercial Code repeats this limitation of the law. Lack of Awareness, socio economic development of the country, lack of a habit of working together, limitation in the law and lack of experience of classes of company shares in Ethiopia are the factors for the absence of the practice of classes of shares. Depending on the findings of this research, the researcher recommends the government to provide laws with a clear legislative intent and the laws governing classes of shares should be detail, clear and flexible. Creating awareness by providing seminars for experts in the area and for the business community is among the tasks the government should undertake.

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Abbreviations

Art	Article
Arts	Articles
NBE	National Bank of Ethiopia
DARA	Document Authentication and Registration Agency
EIC	Ethiopian Investment Commission
Fed.Neg.Gaz	Federal Negarit Gazeta
MoTI	Ministry of Trade and Industry
No.	Number
Proc.No.	Proclamation Number
USA	United States of America

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Business in the form of company may take different forms on the basis of incorporation (statutory or registered), liability (unlimited company, company limited by share, company limited by guarantee or a combination of company limited by guarantee and share, control (holding or subsidiary), and number of members (one-man company, private company or public company).¹ A company limited by share is a registered company where the liability of its member's is limited to the amount of unpaid shares held by them if any.² In companies limited by shares, capital is raised by the issuance of shares and the capital is also referred to as share capital.³ The capital of the company will be divided in to specific number of shares and a fixed amount is allotted to each.⁴ The share capital of a company may be of similar class or of different classes, however, usually contains two types of shares, i.e., equity and preference shares.⁵ Preference shares are shares which give special rights to their holders while ordinary share does not confer any special right. Equity shares may be issued with similar or different rights and obligations.⁶

Issuing different classes of shares is common in public companies; however, private companies may also issue different classes of shares during formation with a view to accommodate the interest of stakeholders.⁷

¹ Types of Companies- Classification and different kind of Companies <<http://www.toppr.com>> accessed on 25 November 2020.

² *Company law* (Lovely Professional University DOCOM106/DMGT201, 2012) 29

³ Kirti Dubey, 'Share Capital: Exploring the Backbone of Company Law' (2018) 7 <<http://researchgate.net/publication/326295273>> accessed on November 30 2020

⁴ *Company Law* (The Institute of Company Secretariats of India, Executive Programme Study Material, Module 2- Paper 4) 145

⁵ Kirti Dubey, (n 3) 14

⁶ *ibid*

⁷ Introduction to Singapore Shares and Share Classes for First Time Entrepreneurs <<https://www.guidemesingapore.com>> accessed on 03 November 2020.

Classes of shares created and issued by companies depend on the provisions of the company's article of association.⁸ Equality among shareholders is the presumption of the law unless the article of association of companies provides a contrary rule.⁹ A departure from the presumption of the law which is introduced in a company's articles of association creates shareholders with a different right or interest in the company.

The difference of rights may be with regard to dividend, voting right, and rights to share assets on winding up and a different purpose and features based on the interests of both a shareholder and the company.¹⁰ However, the commonly used, raised and debated difference is with regard to differential voting right.¹¹ Some classes of shares restrict the voting rights of shareholders while others may give multiple voting rights to their holders.¹² The successful technology companies like Facebook and Google have used this share structure in order to maintain control of the company.¹³ The structure is also important for founders of a company to raise capital without losing control, especially for startups.

Different jurisdictions follow different approaches on classes of company shares. Many jurisdictions allow companies to issue classes of shares with unequal voting rights.¹⁴ Some jurisdictions permit companies to adopt classes of shares with unequal voting right under their company laws but prohibit the same from listed in public markets such as Australia.¹⁵ On the other hand, there are jurisdictions which permit dual class share structure under their company

⁸ Mercy Kihungi, Company- Share- Corporate- Capital <www.academia.edu>

⁹ Arthur Machen, (Treatise on the Modern Law of Corporations with Reference to Formation and Operation under General Laws. Boston, Little, Brown and Co., 1908) 518

¹⁰ Madhuri Thakur, Share Classes <<https://www.wallstreetmojo.com/share-classes/>>, accessed on 25 November 2020.

¹¹ How Class A, B, and C Shares Differ, <<http://smartasset.com/financial-advisor/class-a-shares>>, accessed on 26 November 2020.

¹² ibid

¹³ Madhur Thakur, (n 10)

¹⁴ The Rise of Dual Class Shares: Regulation and Implications, (The Committee on Capital Markets Regulations Executive Summary 2020)

¹⁵ Dual- Class Shares: The Good, The Bad and The Ugly, A Review of the Debate surrounding Dual Class Shares and Their Emergence in Asia Pacific, CFA Institute, 2018) 29 <www.cfainstitute.org> accessed on 22 November 2020

laws as well as under their listing rules such as Canada and United States.¹⁶ There are also jurisdictions which prohibit dual class structure both under their company laws and listing rules such as Spain.¹⁷

Ethiopia for the first time started the corporate form of business undertaking in the 20th century.¹⁸ The first company law was enacted in 1933 during the regime of Emperor Haile Selassie. Thereafter, several laws gave recognition to incorporated forms of business undertakings; the 1960 Commercial Code being the principal. The 1960 Commercial Code (herein after referred as the Commercial Code) recognized two broad forms of business undertaking, i.e., partnerships and companies.

Book two title four of the 1960 Commercial Code recognizes companies limited by shares. The Commercial Code provided regulations on how to start and run share companies in Ethiopia. As indicated above share companies raise their capital through the issuance of shares. Like in many other countries, Ethiopian share companies are permitted to issue shares of different classes.¹⁹ However, restrictions are provided with regard to the issuance of shares which restrict the voting right of shareholder's as well as shares which give multiple voting right.²⁰ Shares which give multiple voting right to the holders are totally prohibited in Ethiopia. However, the Commercial Code allows certain restrictions in the voting rights of shareholders in case of preference shares.

More than six decades had passed since the Ethiopian Commercial Code permitted the issuance of different classes of shares; however, we haven't seen different classes of shares being issued in practice. Only one class of shares are in use in Ethiopia. It is important to investigate why classes of company shares are not practically issued in Ethiopia which is the main concern of this paper.

¹⁶ *ibid* 29

¹⁷ *ibid*

¹⁸ Getahun Seifu, 'Revisiting Company Law with the advent of commodity Exchange' (2010) 4 (1) *Mizan Law Review* 103

¹⁹ Commercial Code of the Empire of Ethiopia, (1960) Extra Ordinary Issue No.3, art 335

²⁰ *ibid* Arts. 345(3) & 336(2)

1.2 Statement of the Problem

Providing flexible and transparent laws is among the first important steps in attracting potential investors to a country, thus laws governing business should be transparent, flexible and up to date in order to meet the expectations and needs of investors.²¹ One of the modes of attracting investment in corporate law is allowing companies to issue classes of company shares which is common and has been used for long in USA.²² The Ethiopian Commercial Code permits the issuance of ordinary, preference and dividend shares.²³ Other classes of company shares like employees share which have significant contribution in the productivity of companies are not recognized.

Though, classes of company shares are regulated in Ethiopia, they are not practically used. Nowadays, even if the involvement of the private sector is relatively growing, the existing investments are not using this mode of investment. However, classes of shares particularly preference shares have a glimmer of hope in Ethiopia, due to the relative growth in the involvement of the private sector. The government's plan to establish capital market and its commitment to enhance the growth of startups are the other events which require the utilization of classes of company share.²⁴ Hence, the factors which prevents the issuance of classes of shares in Ethiopia needs to be identified.

According to the 2009/2010 Global Venture Capital/ Private Equity Attractiveness Index the legal environment is one of the determinants for attracting venture capital. Venture capitalists require certain privileges and protections in order to invest in risky startups.²⁵ Preference shares are important investment tools for venture capital financing.²⁶ Though, preference share terms are provided on negotiation, the law governing preference shares should be clear and flexible to accommodate the interests of both the company and investors. The sufficiency of the commercial

²¹ Tatia Bachvaia, 'Role of Preferred Stock in Corporate Finance: Lessons for Georgia in Light of US Experiences' (LL.M Thesis, Central European University 2016) 1

²² *ibid*

²³ Commercial Code, art 335-37

²⁴ Draft Stock Market Proclamation; Draft Startups Business Proclamation

²⁵ Assefa Aregay, 'Preferred Shares Under Ethiopian Company Law: The Ignored Vehicles of Corporate Finance' (2016-17) 28 JEL 61

²⁶ Charles Kormso, 'Venture Capital and Preferred Stock' (2013) 78 (40) Brooklyn Law Review 1163

code provisions on preference shares in terms of attracting investment in general and venture capital in particulars needs to be researched.

In USA preference shares are in use for a longer period of time as a significant corporate finance tool. In spite of the clear recognition of preference shares under the Ethiopian commercial code, they are not utilized as corporate finance tool. The practical problems that discourage the issuance of preference shares need to be investigated.

To sum up, there are legal and practical issues surrounding classes of company shares in general and preference shares in particular which this research is devoted to examine.

1.3 Objectives of the Study

1.3.1 General Objective

The main goal of this study is to examine the legal and practical dimensions of classes of company shares in Ethiopia.

1.3.2 Specific Objectives

- Examine the factors that hinder the issuance of classes of company shares in practice in Ethiopia.
- Examine the practical problems that discourage the issuance of preference shares in Ethiopia and suggest solutions for that.

1.4 Research Questions

RQ1. Why classes of shares are practically not issued in Ethiopia?

RQ2. What are the practical problems that discourage the issuance of preference shares in Ethiopia and the solutions for that?

1.5 Significance of the Study

The study mitigates the existing gap in the Ethiopian literature on classes of company share as the area do not get a concern despite the fact that it is highly debatable issue at the global level. So, the study brings the agenda of classes of company shares in the academic stage. The study may help the business community to decide whether to issue classes of company shares by clearing showing them the advantage and disadvantages of issuing different classes of company shares. The study also adds the awareness of the business community by showing them ways of

enhancing the capital of their companies. Additionally, the study will give suggestions and information for stakeholders on how to deal with classes of company shares. Above all the main goal of this paper is to find out the factors that hinder the issuance of different classes of company shares in Ethiopia and thereby the study suggests solutions in order to obtain the benefits acquired from issuing varieties of classes of shares.

1.6 Methodology

Research Design

In order to achieve the objective of the study, a qualitative research methodology is used in this paper. This methodology is appropriate for systematically investigating the laws on the subject of the study and to undertake in-depth examination of the factors that hinder the utilization of classes of company shares in Ethiopia. To this end, the views of purposefully selected officials from Document Authentication and Registration Agency (DARA), Ministry of Trade and Industry (MoTI), Ethiopian Investment Commission (EIC), National Bank of Ethiopia (NBE) and lawyers of selected law firms and public companies (share companies) in Ethiopia are analyzed. Additionally, Commercial Code provisions on classes of company shares are critically examined. Qualitative legal research method is more suitable to analyze the data which is obtained from interviews of the mentioned concerned bodies.

Types of Data

Both primary and secondary sources of data are used throughout the study. The primary sources are laws i.e., the Ethiopian Commercial Code with the corresponding provisions under the Draft Commercial Code, Banking Business Proclamation, Insurance Business Proclamation, Investment Proclamation, Document Authentication and Registration Proclamation and data collected through interview. Books, articles, documents and literatures dealing with classes of company shares are secondary sources extensively used for conducting this research.

Data Collection Method

Qualitative data collection tools of interview and legislative analysis are employed to address the research questions. Purposefully selected officials and experts on the basis of experience, position, education from DARA, MoTI, EIC, NBE and law firms and share companies in Ethiopia are interviewed to obtain data relevant to answer the research question. Purposive sampling is found the appropriate sampling technique for this research. Taking in to

consideration the objective of this study institutions and individuals who have a direct concern are selected to obtain the relevant data. Semi-structured interview is appropriate to obtain data relevant to address the research question.

Data Analysis

The study employed qualitative analysis method of content analysis for semi-structured interviews narration where it is found appropriate. Before starting the analysis, the data obtained from interview has been categorized based on the similarity of opinions. Each group of response is given a code and systematically examined with a view to identify important points and draw conclusions. The researcher verified the data and draw conclusions in line with the research questions and objectives.

1.7 Limitation of the Study

Lack of awareness of the concepts of classes of company shares in general and preference shares in particular created difficulties in collecting data from officials and experts at DARA and MoTI. The researcher had faced similar challenges while collecting data from share companies in Ethiopia. Lack of domestic literature on the area of the study is the other limitation the researcher has faced while conducting the study. However, an attempt is made to review foreign literatures on the area of study and adopt it to the Ethiopian context.

1.8 Scope of the Study

The study primarily dealt on the concept of classes of company shares and the approaches followed by countries in general and the Ethiopian approach in particular with regard to classes of company shares. To this end, the 1960 Commercial Code and the new Commercial Code provisions on classes of company shares are covered in the study.

Regarding the jurisdictional coverage of the study, the study will cover companies registered by the federal government and hence data will be collected from federal officials, lawyers of selected law firms and companies registered by the federal government.

1.9 Ethical Considerations

The researcher has been bound by certain ethical considerations. The willingness of the participants in the data collection process is asked priory before taking the data from them. The researcher also refrains from disclosing the name of the respondents in cases when the

respondents do not want. The researcher also refrains from recording the voices of respondents in case where they are not willing. Third, the researcher gave recognition to the contributions of respondents in the acknowledgement part.

1.10 Structure of the Study

The study consists five chapters. Chapter one is about general introduction and hence all the components of a research proposal are provided. Chapter two provide general remarks on classes of company shares in general. Definitions, rationales, significances and the global debate on classes of company shares are discussed under this chapter. Chapter three specifically deals on preference shares. Matters like definitions, features, advantage and disadvantages, kinds and the role of preference shares in corporate finance are the subjects of discussions under this chapter. Under the fourth chapter, the legal and practical dimensions of classes of company shares are carefully examined. The legal limitations as well as the practical problems that hinder classes of shares from being used in practice are explored in this chapter. Finally, the fifth chapter provides conclusions and recommendations.

CHAPTER TWO

GENERAL OVERVIEW ON CLASSES OF COMPANY SHARES

2.1. The Concept of Classes of Company Shares

2.1.1. Definition of Company Share

The term share in corporate law has been defined by many jurists, statues and judicial decisions.²⁷ The definitions of the term share varied through time and still giving a clear-cut definition for the term “share” remains controversial.²⁸

Black’s law dictionary defined the term “share” as, “... one of the definite numbers of equal parts in to which the capital stock of a corporation or joint stock company is divided.”²⁹ This definition of share is general and does not give the full picture of the concept of share. Only a single feature of share as a definite portion of the capital of the company is reflected in the definition. In the same source it is written that “A share represents an equity or ownership interest in the corporation or joint-stock company.”³⁰ This description of share as an ownership interest is replicated in many other writings. Defining shares as an ownership interest does not give full description of “share” since it is difficult to exactly determine the nature and base of ownership interest of a shareholder.

The most famous judicial definition of “share” that is usually raised in literatures is that of Farwell J in the case of *Borland’s Trustee v Steel*. In this case share is defined as:

.... a share is the interest of a shareholder in the company measures by a sum of money, for the purpose of liability in the first place, and of interest in the second place, but also a series of mutual covenants entered in to by all the shareholders inter se in accordance with {s 14}. The contract contained in the article of association is one of the original incidents of a share. A share is not a sum of money but an interest measured by a sum

²⁷ Duru, Onyekachi Wisdom Ceazar*, ‘MY “SHARE” IN THE COMPANY: WHAT IS IT?’ <<http://ssrn.com/abstract=2140364>> accessed on 18 November 2020

²⁸ ibid

²⁹ Bryan A. Garner, *Black’s Law Dictionary* (8th edn, 2014)

³⁰ ibid

*of money and made of various rights contained in the contract, including the right to a sum of money of a more or less amount.*³¹

Scholars basically rely on this definition in their attempt to define the term share. This definition of share mainly focuses on the interest of shareholders in the company and its contractual nature. However, this definition of share obscures the distinction between share and debenture by assuming share as a bundle of contractual and statutory rights.³² The definition disregards the shareholders attachment to the company which distinguishes them from debenture holders. The shareholders interest in the company and their role in the governance of the company distinguish the shareholder from debenture holders.³³ This definition also conceptualize share as a proprietary interest of shareholders but as mentioned above it is difficult to determine the exact nature and base of proprietary interest of shareholders.

Giving a comprehensive definition for the term “share” has been a challenging task for both jurists and judiciaries. For the purpose of this paper a “share” is defined as a unit of the capital of a company that measures the interest of shareholders in the company which contains certain rights and liabilities provided either in the articles of association or memorandum of association and which has a protection of the law.

2.1.2. Nature and Classes of Company Shares

2.1.2.1. Nature of a Company Share

Shares in a company do not confer a right to the physical possession of anything other than a bundle of rights to their holders.³⁴ The rights of shareholders in a company may be either statutory or contractual. Thus, Shareholders in a company may have identical or different rights.

³¹ {1901} 1 CH 288, cited in Simon Goulding, *Company Law* (2nd edn, Cavendish Publishing Limited 1999) 205

³² Duru Onyekachi Wisdom Ceazar*, (n 27) 8

³³ Janet Dine, ‘*company Law*’ (3rd edn, Macmillan Law Masters 1998)259

³⁴ *ibid*

The specific contents of the rights conferred to shares may also vary across jurisdictions, across companies and across different classes of shares.³⁵

The principal rights which may be conferred by owning a company share are an entitlement to dividend when declared, the right to vote in member's meeting and an entitlement to the company's asset upon the winding up of the company.³⁶ In addition to these principal rights shareholders have also the right to information like the right to receive notice of members meetings, a copy of balance sheets, a copy of memorandum and articles of association and a copy of minutes of the general meetings.³⁷ Various individual and corporate rights also result from owning shares of a company which emanates from law or articles of incorporation of the company like petition right for remedies on different situations of the company, for winding up of the company being one instance.³⁸ Shares do not only endow rights rather they are connected with certain liabilities like the duty to pay the nominal value of the share.³⁹

2.1.2.2. Classes of Company Shares

Normally, Shareholders are presumed to have equal right to enjoy the bundle of rights acquired from owning a share.⁴⁰ Thus, they are presumed to have equal right in voting, dividend sharing and division of capital if any left upon winding up of the company. The presumption of equality of shareholders, however, can be rebutted if different classes of shares which confer different class rights are provided either in the memorandum of association or articles of association during incorporation of the company or latter through amendments.⁴¹ We can here raise preference share as an example, i.e., holders of preference shares enjoy preferred right in

³⁵ Ahmed EL-Masry, Nahla Kamal, 'Shareholder rights, Encyclopedia of Corporate Social Responsibility' (2013) <<http://link.springer.com>> accessed on 20 January 2021

³⁶ Clive M. Schmitthoff and James H. Thompson, '*Palmer's Company Law*' (21st edn, Stevens and Sons Limited 1968) 280

³⁷ *ibid*

³⁸ *ibid*

³⁹ *ibid*

⁴⁰ Alan Dignam, John Lowry, Chris Riley, *Company Law*, (module guides, University of London 2016) 102

⁴¹ *ibid*

dividend sharing and priority right in the return of capital upon winding up. When a company issues different types of shares which confer different rights and liabilities, they are referred as classes of company shares.⁴² The different classes of shares in a company may be for the purpose of dividend distribution, voting rights, priority on the return of capital, etc. Thus, classes of shares are created in a company when the whole or parts of the general rights of shareholders are varied in relation to some part of the total share capital of a company.⁴³

However, we don't find the term classes of company shares when we go through different literatures, we rather get terms like dual/multiple classes of shares or share classes. There is no consensus in different literatures on the use of the term dual class share. Usually it is defined in literatures as a classification of companies share on the basis of voting right.⁴⁴ According to this definition, shares which confer different voting rights to their holder are called dual class shares. There are also literatures that use the term dual class shares interchangeably with multiple class shares by defining it as a share classification whereby the company issues different classes of shares which confer different voting rights to their holders and the term dual class share refers to the existence of at least two classes of shares with unequal voting rights.⁴⁵ Classes of shares issued by companies may not necessarily be only on the basis of differential voting right. Additionally, the word dual is usually used to refer to the existence of two things and thus readers may understand dual class shares to refer to the issuance of two type of shares in a company. Hence, this paper refrains from using the term dual class shares in order to avoid confusions on the use of the term.

The word share can be used in different contexts and hence it is vital to expressly and clearly provide the context in which the word is used. In this paper, the word share is used in the context of corporate law and hence the term classes of company shares are found to be the appropriate term to clearly show what this paper is about. However, the terms share classes, multiple class

⁴² *ibid*

⁴³ Murray A Pickering, 'The Problem of Preference Shares', (1963), 26 *Modern Law Review* 499

⁴⁴ Flora Huang, 'Dual Class Shares Around the Top Global Financial Centers' (2017) 2working paper journal of business law 137; Dual class shares: The Good, the Bad and the Ugly, (n 28) Executive summary

⁴⁵ Gabriel Morey, 'Multi-Class Stock and Firm Value: Does Multi Class Stock Enhance Firm Performance?: A Regression Analysis' (2017) Council of Institutional Investors <www.cii.org/files/publications/misc/05-10-17-dual-class-value-study.pdf> 4, accessed on 28 November 2020

share and classes of company shares is used interchangeably throughout this paper to refer to varieties of shares in a company which confers different right to their holders.

2.2. Rationales for Issuing Classes of Company Shares

Issuing classes of company shares is common in many parts of the world. According to research in 2001 more than 80% of Canadian companies have multiple class share structure.⁴⁶ In Canada the number of companies going public with a multi class share structure is increasing significantly.⁴⁷ Majority of successful technology companies like Google and Facebook use a multiple class share structure.⁴⁸ There are various rationale for issuance of varieties of shares in corporations. However, the rationale for the issuance of certain classes of shares is different when we go across different classes of shares. The motives of companies for issuing varieties of company shares may also be different. Some of the rationales for issuance of classes of shares in a company are:

To maintain control of the Company: Though issuance of different classes of company shares is still hotly a debatable issue, having classes of company shares is not a new phenomenon. Founders have used this multiple share structure to raise capital while at the same time keeping the control of the company.⁴⁹ Multi class share structure also helps founders to retain strategic decision making in the company and achieve their long-term business goal, especially for technology companies.⁵⁰ This can be achieved by retaining voting power to themselves and restricting it to other class.⁵¹ In 1980 corporations used multi class share structure as a hostile takeover protection.⁵² Thus, it can also serve as anti-hostile takeover protection tool.

⁴⁶ Aurlio G. Martinz, 'Theory, Evidence, and Policy on Dual Class Shares: A Country- Specific Response to A Global Debt' (2019) Ibero-American Institute for Law and Finance Working Paper 3/2019, 6 <<http://ssrn.com/abstract=3397880>> accessed on 14 November 2020

⁴⁷ ibid

⁴⁸ Dual class shares, the Good, the Bad and the Ugly, (n 15)

⁴⁹ Stephani Ben-Ishai and Poonam Puri, 'Dual Class Shares in Canada: An Historical Analysis' (2016), Dalhausi LJ 117

⁵⁰ Dual class shares, The Good, the bad and the ugly, (n 15)

⁵¹ Share Class- Overview, Types, Creating Multiple Classes (2015-20) <<https://corporatefinanceinstitute.com/resources/knowledge/finance/share-class/>> accessed on 16 November 2020

⁵² Katie Bentel and Gabriel Walter, 'Dual Class Shares',(2018), Seminar Paper on Comparative Corporate Governance and Financial Regulation 2, 15 <<https://scholarship.law.upenn.edu/fisch-2016/2>>accessed on 20 October 2020

To create a sense of ownership on employees: companies may issue shares to employees and make them feel as owners of the company, to motivate and retain employees and this in turn have its own contribution in the productivity of the company.⁵³ Hence, multi class share structure creates this feeling on employees without relinquishing control.⁵⁴

To attract investment: Preference shares contain preference economic benefit over ordinary shares and thus they have a high potential to attract investors. Some investors may be more interested in high yields than control right.

To make Payments in a more tax efficient way: Companies may issue shares to employees and shareholder's families in order to make payments to them. This will happen when issuing share is more tax efficient way of effecting payment than other modes of effecting payments.⁵⁵ In such circumstances the company may make such shares redeemable and non-voting in order to limit the rights attached to them.⁵⁶

To Raise Capital: The commonly raised rationale for the issuance of varieties of classes of shares in a company is to raise capital without losing control of the company.⁵⁷ This is the major reason why corporations issue preference shares.⁵⁸ Issuing shares is not the only mode of raising capital without losing control of the company and a company may also prefer to raise its capital through debt arrangement. But there may be situations where the company is required to meet certain minimum capital requirements or a company's debt to equity ratio may be a determining factor to get more debt. And hence, in such circumstances the company may issue shares with restricted rights for the purpose of acquiring debt. Above all, issuing varieties of shares helps a company to attract investors by conferring different rights and privileges and thereby widens the capital market.

⁵³ Share Class-Overview, Types, Creating Multiple Classes, (n 51)

⁵⁴ Stephani Ben- Ishai and Poonam Puri, (n 49)

⁵⁵ *Company Law*, (a part of the course by Jaipur National University 2013) Sec1:25

⁵⁶ *ibid*

⁵⁷ Katie Bentel and Gabriel Walter, (n 52)

⁵⁸ *ibid*

2.3. Varieties of Classes of Company Shares

Ordinary Shares: is the most commonly issued class of share. Ordinary shares confer voting right usually each share carries one vote unless a contrary provision is provided either in the memorandum or articles of association, dividend right when declared and the right to share surplus assets if any upon winding up of the company.⁵⁹ Ordinary shareholders are presumed to have one vote per share, right to participate in dividend distribution and a right to share any surplus asset during winding up of the company in proportion to their shareholding.⁶⁰ However, companies may create different classes of ordinary shares.⁶¹ Different classes of ordinary shares are created with a view to create small differences which may be different dividend payments, to apply different rules for share transfer or to create deadlock articles.⁶² Unless the articles of association of a company provides to the contrary, there is no difference between shares and all shares in the company are presumed as ordinary shares with similar rights and liabilities.⁶³

Preference Shares: as the name indicates they are shares which confer special or preference right to their holders, preference right to a fixed amount of dividend being the most common.⁶⁴ The preference right created through the issuance of preference share is determined by companies.⁶⁵ Thus, the definition of preference shares may vary when we go through different companies. Preference shares usually contain a fixed amount of preferential dividend.⁶⁶ Preference right to subscriptions of newly issued shares and priority right on the return of capital upon winding up are the other preference rights which may be obtained or acquired from preference shares. Preference shares are often non-voting.⁶⁷

⁵⁹ Janet Dine, (n 33)

⁶⁰ *Company law*, (n 55)

⁶¹ *ibid*

⁶² *ibid*

⁶³ *Corporate and Business Law Study Text*, (2010) ACCA Paper F4, 259 <<http://freefor911.wordpress.com>> accessed on 18 November 2020

⁶⁴ *ibid*

⁶⁵ *Company Law*, (n 55)

⁶⁶ *ibid* Sec1:26

⁶⁷ *ibid*

Non-voting Shares: as the name indicates; such kind of shares does not give voting rights to their holder. Such kind of shares usually issued to employees as a tax efficient way of effecting payment and to families of shareholders.⁶⁸ Companies also issue non-voting shares in order to maintain control of their company.

Redeemable Shares: a company may issue shares which can be redeemed by the company at their nominal value at some stipulated date in the future or at the directors' discretion, provided that there are sufficient distributable profits available. Non-voting shares given to employees and preference shares are often redeemable.⁶⁹

Management/Founder Shares: are shares which carry multiple voting rights in order to retain control of the company.⁷⁰ Such kind of shares enables existing shareholders to maintain control of their company after additional shares have been sold to outside investors.

Dividend Shares, Capital Shares, and Voting Shares: Shares may confer a bundle of rights to their holder. However, the bundle of rights may be unbundled and create different classes, conferring different rights for their holder. These different classes may be provided for certain purpose.⁷¹ The bundled shares may be disintegrated to create different classes of shares, i.e., one class having all the dividend rights (dividend shares), one class having all the capital rights (Capital shares) and the other class having all the voting right (voting shares).⁷² Different shareholders may have different percentage of shareholding from the different classes of shares.⁷³ For example, a certain shareholder may have 30% of the dividend right, 20% of the capital rights and 70% of the voting rights.⁷⁴

⁶⁸ *ibid*

⁶⁹ *ibid*

⁷⁰ *Company Law*, (n 55) Sec1:26

⁷¹ *ibid*

⁷² *ibid*

⁷³ *ibid*

⁷⁴ *ibid*

2.4. Variation of Class Rights

Class rights can be created by the memorandum of association, articles of association, terms of issue or by special resolution.⁷⁵ The special class rights could be with regard to dividend, voting or division of asset upon the dissolution of the company. When different classes of shares are permitted, it is important to ascertain whether the rights attached to a certain class can be varied or changed, if so, the procedures of varying it. It is also necessary to ascertain whether the rights are defined either in the memorandum or articles of association. What constitutes a variation of class rights is the other important question that needs to be answered. The case laws on the issue follow a restrictive approach and have made a distinction between acts which affects the substance of the class rights and acts which merely affect the enjoyment of the class rights.⁷⁶

The procedure for effecting alteration of class rights is the other important issue that needs to be addressed. Usually the procedures are provided in legislations and this statutory requirement is meant to protect the class rights of shareholders from being exposed to simple variation by altering either the memorandum or articles of association or by shareholders resolutions.⁷⁷ The German legislations provide detail rules on how the creation of new classes or a modification to the rights in the existing classes should be approved.⁷⁸ In German, as a matter of rule, it is assumed that the creation of any classes of shares that has superior or equal to an existing class of shares will alter the proportionate value of the preexisting rights, and must be specially approved by the affected persons.⁷⁹

Generally, when we talk about classes of shares it is must to consider whether variation of class is permitted or not and if permitted a clear procedure of doing it shall be clearly provided starting from defining what a class right is? What variation of class right constitutes?

⁷⁵ Clive M. Schmitthoff and James H. Thompson, (n 36) 285

⁷⁶ Alan Dignam, John Lowry, Chris Riley, (n 40) 103

⁷⁷ *ibid*

⁷⁸ Andreas Cahn, David C. Donlald, '*Comparative Company Law*' (Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press 2011) 269

⁷⁹ *ibid*

2.5. Significances of Permitting the Issuance of Classes of Company Shares

One of the most important attributes of a country's economic growth is ensuring that legislative rules are drafted in a way that they can accommodate investors need and expectations in order to boost investments.⁸⁰ Flexible regulatory frameworks are needed to attract investors and make a country comfortable for starting business and make corporations and the country benefits from the growth of market economy. It is vital to make sure that the corporate law is up to date and meets the expectation of the business world.

As discussed earlier, companies issue different classes of company shares for various rationales with a view to achieve the specific needs of each investors and the issuing company. These specific needs can be fulfilled through the issuance of different classes of shares. Though, there are a number of reasons why companies issue classes of company shares, the economic and governance significances are the principal significances of issuing variety of classes of shares. As noted earlier, shares entitle economic rights like regular dividend right when declared and an entitlement to surplus asset upon winding up; they also confer right to control the company such as the right to appoint directors and decide on the core activities of the company.⁸¹ These rights can be customized to meet the specific needs of each type of investor. The economic significance includes its ability to widen the capital market and thereby mitigate financial problems of companies. Allowing founders to control voting right is the governance significance of this form of share structure.

2.6. The Global Debate on Classes of Company Shares

There are various issues on the debate over classes of company shares. Some of the debatable issues are on the desirability of multi class share structure, its effect on corporate governance,

⁸⁰ Tatia Bachvaia, (n 21)

⁸¹ Andreas Cahn, David C. Donald, (n 78) 264

valuation of multi class shares, performance of multi class share companies, etc.⁸² There are strong arguments both in favor and against multi class share structure.

Multiple class share structure is a share structure in a company whereby one class of shares are conferred with voting right which is not proportional to their economic contribution.⁸³ Such kind of structures is usually used by founders who offer their shares to the public in order to raise capital.⁸⁴ The structure allows founders to retain control of their company while accessing the public capital.⁸⁵ Even if multi class share structure has vast significance, almost an equivalent amount of criticisms are provided in corporate literatures. Multi class share structure's role in the achievement of founder's long-term plan, role in encouraging innovation and entrepreneurship are among the principal justifications raised by proponents of multi-class share structures.⁸⁶

On the other hand, Opponents are of the view that multi class share structures unbundle control and economic rights which permits minority shareholders to maintain control of the company though majority of the share capital is provided by outside investors.⁸⁷ The minority controlling shareholders do not bear the financial risk of their actions and hence they may act carelessly, abuse their power and may act to fulfill their private benefit at the expense of majority shareholders. Opponents of multi class share structure describe this potential act of minority shareholders by the agency theory.⁸⁸ Thus, shareholders who have conflicting interest may act in their own interest at the expense of the other. They further argue that minority control has a tendency to strength the conflict of interest among minority and majority shareholder.⁸⁹ On the contrary, there are scholars who suggest that control rights and invested capital should not

⁸² Abdullah*, Jia'nan Zhou, 'Dual Class Firms: a comprehensive Literature Review' (Advance in Economics, Business and Management Research, Atlantis Press 2017) 33

⁸³ Jinhee Kim, Pedro Matos*, Ting Xu, 'Multi Class Shares Around the World: The Role of Institutional Investors' (2018) 1

⁸⁴ *ibid*

⁸⁵ *ibid*

⁸⁶ Elliott Pierre, 'Share Classification and Corporate Control' (Master Thesis, University of Zurich 2016) 6

⁸⁷ *ibid* 7

⁸⁸ *ibid*

⁸⁹ *ibid*

always be proportional by arguing that multi class share structure may reduce agency problems among the minority and majority shareholders.⁹⁰

Opponents of multi class share structure also assume that this structure of corporate governance may led to lower performance and decrease firm value and decrease corporation's engagement in the "market for corporate control".⁹¹ Multi class share structure is also criticized for breach of one share one vote rule.⁹²

Despite the presence of these controversies on multi class share structure, there is some consensus on the need to permit multi class share structure due to the fact that in the absence of multi class share structure founders and entrepreneurs may be reluctant to take their companies public if they could not retain control.⁹³ This may in turn negatively affect the growth of new emerging companies. It also deprives investors of the opportunity to invest in growth company.⁹⁴ Optimists believe that allowing multi class share structure and thereby permitting founders to retain control of their company make entrepreneurs to publicize their ideas at an early stage and make long term plans.⁹⁵

Some scholars hold the view that there is no social justification to limit the type of share structure a company may adopt since companies will use certain share structure if it has more advantage than the cost.⁹⁶ But more realists believe that the debate should not be focused on whether multi class share structure should be permitted or not rather the center of focus should be on how to use it efficiently by reducing the costs and risks attached to it.⁹⁷

⁹⁰ Augusto Santoro and Ciro Di Palma and Paolo Guarneri and Alexandro Capogrosso, 'Deviations from the One Share- One Vote Principle in Italy: Recent Developments-Multiple Voting Right Shares and Loyalty Shares' (2015) 5 Bocconi Legal Papers 141

⁹¹ *ibid*

⁹² *Ibid*

⁹³ Flora Huange, (n 44) 143

⁹⁴ 'Dual -Class Shares: The Good, The Bad and The Ugly, (n 15)

⁹⁵ Flora Huange, (n 44) 153

⁹⁶ *ibid* 143

⁹⁷ *ibid*

In spite of the controversies surrounding multi-class share structures, many growing companies, especially technology companies are increasingly using this form of share structure.⁹⁸ Hence, despite the debates, as the realists suggests, it is better to design mechanisms for efficient utilization of multi-class share structure.

⁹⁸ Hao Chen, 'One-Share One-Vote Rule and the Future of Dual Class Shares Structure in China' (LL.M Thesis, University of Gent 2015) 48

CHAPTER THREE

PREFERENCE SHARES AND THEIR ROLES IN CORPORATE FINANCE

3.1. Definition and Nature of Preference Shares

Classes of company shares are created where the total or some part of the general rights of shareholders within a company are differed in relation to some part of the total share capital.⁹⁹ The most common classes are usually those created when preferential rights are conferred, in which case the shares concerned may be termed preference shares.¹⁰⁰ The main rights varied on the creation of preference share is income right, fixed dividend in priority to payment of dividend to other shares.¹⁰¹

Preference shares are one type of shares a company can issue. Preference shares as the name indicates are shares which give a preferential right to their holders. They give preference/priority to their holders over the ordinary shareholders.¹⁰² However, the type of preference rights created may vary across companies. Because, preference shares do not emanate from law rather they are contractual creations. Hence, the right of a preference shareholder is determined by the preference share contract or by the terms of issue. Hence, there is no single or bundle of features that can be used to define preference shares uniformly found in each issuance.¹⁰³ They rather come in different varieties.

The right to a fixed dividend is the most common right conferred to the holders of preference shares.¹⁰⁴ Normally, dividend is distributed in proportion to a shareholding and hence the amount of dividend shareholders may obtain is not known until it is paid. This rule is usually changed when preference share is issued i.e., preference dividend is usually predetermined. However,

⁹⁹ Murray A Pickering, 'The Problem of Preference Shares' (1963) 26 *Modern Law Review* 499

¹⁰⁰ *ibid*

¹⁰¹ *ibid*

¹⁰² Shofian Ahmad and Marina Abu Bakar, 'The Status of Preference Shares from Islamic Perspective' (2017) 7 (10) *International Journal of Academic Research in Business and Social Science* 617 <<http://dx.doi.org/10.6007/IJARBS/v7-i10/3416>>, accessed on 25 February 2021

¹⁰³ Charles R. Korsmo, (n 26)

¹⁰⁴ *Corporate and Business Law Study Text*, (n 63) 259

preference shares which entitle a variable rate of dividend is becoming common in recent years.¹⁰⁵ Priority right on the return of capital upon winding up of company is also the usually conferred right of preference shareholders.¹⁰⁶ Preference shareholders may also enjoy the prior subscription right when new shares are issued.¹⁰⁷

3.2. Features of Preference Shares

Preferential Right

Preference shares have no legal meaning but it is obvious from the word 'preference' that this class of share carries at least one preference right over other classes of shares, particularly ordinary shares and clearly indicate that preference shareholders have different right than ordinary shareholders. They carry at least one preference right such as preferred right to entitlement of dividends declared by the company for distribution. Besides, the fact that preference dividend is predetermined or fixed makes it distinct from ordinary shares. The rights of preference shareholders are determined by either memorandum or articles of association of the company.¹⁰⁸

Hybrid Feature

The other distinct nature of preference share is its hybrid feature.¹⁰⁹ It has some characteristics of equity and some characteristics of debt.¹¹⁰ Like equity share they represent ownership interest in a company and they have no maturity date for payment of a fixed amount. These features make it equity. However, like debt they are usually non-voting and entitle a fixed amount of dividend. Even if preference shares carry an entitlement to a fixed amount of dividend, the actual payment of dividend is not compulsory rather it depends on the discretion of the company.¹¹¹

¹⁰⁵ Denzil Watson and Antony Head, *Corporate Finance Principles and Practice* (4th ed, Pearson Education 2007) 111

¹⁰⁶ *ibid*

¹⁰⁷ *ibid*

¹⁰⁸ *ibid*

¹⁰⁹ Balarma Bora, 'Preference Shares Role in India Companies' (2015) 3 (2) *International Journal of Conceptions on Management and Social Sciences* 8/50

¹¹⁰ *ibid*

¹¹¹ Simon Goulding, 'Company Law' (2nd edn, Cavendish Publishing Limited 1999) 214

Cumulative Dividend Right

Dividend rights of preferred shareholders is contractual, however, usually dividend is cumulative.¹¹² Cumulative dividend right allows shareholders to get the arrears of accumulated dividend in cases the company has declined to declare dividend in any year.¹¹³ The question of whether preference shareholders are entitled to a cumulative dividend right or not are determined by either the memorandum of association or terms of issue, however, usually they are entitled to a cumulative dividend right. This feature of preference shares makes it distinct from ordinary shares and makes them potentially attractive for investors.

Participatory Right and Convertibility Feature

Preference shares may entitle dividend right in excess of the fixed preference dividend. They may also entitle participatory right during winding up in cases where surplus asset is found.¹¹⁴ A preference share may also allow the preference shareholder to convert the whole or part of their shares in to ordinary shares at a fixed price in a definite period of time.

Redeemable or Callable Features

A company may redeem preference shares at a stipulated buy back or call price in accordance with a fixed term or on terms provided by the company.

Voting Right when Preference dividend is in arrears

Preference share may or may not entitle voting right to their holders. Though preference share is usually non-voting it entails voting rights when dividend is in arrears.¹¹⁵ They may also be entitled to vote on matters which affect their interest.¹¹⁶

Heterogeneous Feature

Preferred share specifically when used in venture capital financing is “hardly a one -size- fits -all security”.¹¹⁷ Rather preferred share is customized in accordance with the specific interests of

¹¹² Richard M. Buxbaum, ‘Preferred Stock—Law Draftsmanship’ (1954),42 (2) California Law Review 243

¹¹³ Clive M. Schmitthoff and James H. Thompson, (n 36) 290

¹¹⁴ *ibid* 299

¹¹⁵ Balarma Bora, ‘Preference Shares Role in Indian Companies’ (2015) 3 (2) IJCMSS, 8

¹¹⁶ *ibid*

¹¹⁷ Charles R. Korsmo, (n 26) 1171

venture capitalists.¹¹⁸ The terms of preference shares are negotiated carefully by considering the needs of the circumstances and the interests of investors.¹¹⁹ Therefore, we need to be cautious in our attempt to give conclusions about preference shares and preference shareholders.

3.3. Kinds of Preference Shares

There are various kinds of preference shares on the basis of different grounds.

On the basis of entitlement to arrears of dividend: Preference shares can be categorized as cumulative and non-cumulative preference shares.¹²⁰ Preference shares which entitle arrears of dividend are cumulative while shares that do not entitle arrears of dividend are non-cumulative preference shares.¹²¹

On the basis of the right to participate in surplus profit in addition to their fixed dividend: In addition to a fixed rate of dividend preference shares may confer a right to participate or share surplus capital if any after ordinary shareholders are paid.¹²² Such kinds of preference shares are called participatory preference shares.¹²³ While those preference shares that do not entitle their holders a right to surplus profit are called as non-participatory shares.¹²⁴

On the basis of the company's right to buy back: a company may receive the right to buy back preference shares issued by it upon an agreed fixed time or on the discretion of the directors of the company.¹²⁵ Those preference shares which a company may buy back are called as redeemable preference shares while those that do not subject to redemption are called irredeemable preference shares.

¹¹⁸ ibid

¹¹⁹ ibid

¹²⁰ Satvir Kaur, *Share Capital* (2015) 4 (1) IJBMI <www.ijbmi.org> accessed on 20 March 2021

¹²¹ ibid

¹²² ibid

¹²³ ibid

¹²⁴ ibid

¹²⁵ ibid

On the basis of convertibility in to ordinary shares: preference shares which can be converted in to ordinary shares are called convertible preference shares.¹²⁶ While those that have no option to convert in to ordinary shares are called non-convertible preference shares.¹²⁷ Convertible preference share can be optionally convertible or mandatorily convertible preference shares.¹²⁸

3.4. Advantages and Disadvantages of Preference Shares

The advantages and disadvantages of preference shares are usually seen in comparison with ordinary shares and debt security. Besides, both the advantages and disadvantages of preference share are seen from the point of a company and from the side of investors and usually they are correlated (i.e., the advantage of preference shares for the company may be a disadvantage for the investor). Some of the advantages and disadvantages of preference shares are distend to certain types of preference shares.

Preference shares have numerous advantages for both the company and the investor; however, it has also its own shortcomings. The followings are some of the advantages and disadvantages of preference shares both from the side of the company and the investor.

3.4.1. Advantages of Preference Shares

The followings may be mentioned as advantages of preference shares.

A. Advantage for a Company

Source of Finance: In addition to debt and ordinary shares, preference shares as a hybrid instruments can serve as important source of finance for companies.¹²⁹

No dilution of control rights: preference shares are usually non-voting and this nature helps the company to retain control.¹³⁰

¹²⁶ Kirti Dubey, (n 3)

¹²⁷ ibid

¹²⁸ Preference Shares, Handbook on Capital Market Regulations 44 <<http://PDFFile5b28ccee440020.69822772.pdf>>

¹²⁹ Advantages and Disadvantages of Preference Share, <http://www.coursehero.com/file/27417525/8docx/> accessed on 20 April 2021

¹³⁰ Advantages of Preferred Stock Financing <<https://accountlearning.blogspot.com/2013/01/advantages-of-preferred-stock-financing.html>> accessed on 28 February 2021

Reduce the Cost of raising capital: preference shares have lower risk to investors when compared with ordinary shares and this reduces the cost of raising capital.¹³¹ This is the relative advantage of preference shares when compared with ordinary shares. When compared with debt the cost of raising preference share capital is higher.

No compulsory Payment: Unlike debt companies are not compelled to pay dividend to preference shareholders unless there exists sufficient amount of profits to pay them.¹³² Legally a company is not compelled to pay preference dividend, but continuous skipping of payment will negatively impact the company's image.

Preserve debt capacity: There might be situations where certain minimum capital requirements are set for the purpose of obtaining debt and this can be achieved through the issuance of preference shares without losing control of the company. Since preference shares are also considered as equity, they have the capacity to reduce the debt to equity ratio of the company. Besides, unlike debt financing a company is not required to give a security when financing through preference shares.¹³³ This makes the company's asset free from any obligation and helps the company to preserve its debt capacity.

Low risk compared with debt: preference shareholders are legally recognized as owners of a company and hence they do not bring a bankruptcy proceeding to the company.¹³⁴ They are not also entitled to appoint a receiver during non-payment of dividend.¹³⁵ This makes financing with preferred shares less risky than debt financing.¹³⁶

¹³¹ *ibid*

¹³² Denzil Watson and Antony Head, (n 105) 112

¹³³ Advantages and Disadvantages of Preference Shares <<http://efinancemanagement.com/advantages-and-disadvantages-of-preference-shares.html>> accessed on 26 February 2021

¹³⁴ Advantages of Preferred Stock Financing , (n 130)

¹³⁵ Chapter 7-Sources of Finance, <www.fao.org/3/w4343e/w4343e08.htm> accessed on 28 February 2021

¹³⁶ *ibid*

Facilitate reorganization/restructuring: when a company is reorganized, the board of directors in consultation with the creditors can convert debts in to preference shares.¹³⁷

Serve as an alternative to debt: for companies who have no stable income to provide for regular debt interest, preference shares can be issued as an alternative to debt.¹³⁸

Widens the capital market: There might be investors who are more interested in higher return with a minimum risk and issuing preference shares widens the capital market.¹³⁹

No liability to redemption: A company is not liable to redeem preference shares even the redeemable preference shares.¹⁴⁰ They are redeemed out of accumulated profits or out of proceeds of fresh issue of shares.¹⁴¹ There are no penalties for delay of redemption of preference shares.

Enhance the Creditworthiness of companies: Company's debt to equity is one of the commonly raised determinants of the financial status of a company.¹⁴² Preference share is considered as a part of the net worth of the company and hence issuing preference shares instead of debt enhances the creditworthiness of the company.¹⁴³

¹³⁷ Advantages and Disadvantages of Preference Shares ,<<http://accountlearning.com/advantages-and-disadvantages-of-preference-shares/>> accessed on 28 February 2021

¹³⁸ ibid

¹³⁹ Deepti Verma, 'The Advantages and Disadvantages of Preference Shares-Explained!' <<http://www.shareyouressays.com/knowledge/the-advantages-of-preference-shares-explained/102133>> accessed on 8 March 2021

¹⁴⁰ Preference Shares: Types, Features and Advantages (Accounting Notes) <<http://www.accountingnotes.net/preference-shares-types-features-and-advantages.html>> accessed on 25 February 2021

¹⁴¹ ibid

¹⁴² ibid

¹⁴³ ibid

Flexible mode of Financing: preference shares are flexible enough to accommodate terms and conditions that best meets the needs of the company and the investor.¹⁴⁴ Preference share is more flexible than debt when a company is under financial distress or when it comes to non-payment of annual dividend.¹⁴⁵ Additionally, preference shares have no maturity date except for those redeemable preference shares. Preferred shares have also flexibility in shaping the capital structure by providing a call provision.

B. Advantages for Investors

Priority right to dividend and return of Capital: preference shares entitle preferential right to payment of dividend and prior right to return of capital.¹⁴⁶

Secure Income and Capital: as we have mentioned above, preference shares usually carry preference right to entitlement of a company profit available for distribution. This feature of preference shares in addition to entitling them a preference over ordinary shares, guarantees more security of earning and capital, in case the priority right includes return of capital upon winding up of a company.¹⁴⁷

Entitle Higher Yield: Payment of preference dividend is not guaranteed and hence preference shares tend to have higher return when compared with other fixed income financial securities such as bonds.¹⁴⁸

Additional Benefits: In case of cumulative preference shares the accumulated arrears of dividend secure regular profit for the investor.¹⁴⁹ Convertible preference shares allow the investor to trade on the preference shares for a fixed number of shares.¹⁵⁰ Participatory

¹⁴⁴ Johnathan Korchak, 'What are Preference Shares?' (2019) <<http://www.informdirect.co.uk/shares/preference-shares/>> accessed on 26 February 2021

¹⁴⁵ Advantages of Preferred Stock Financing, (n 130)

¹⁴⁶ ibid

¹⁴⁷ Corporate and Business Law Study Text, (n 63) 260

¹⁴⁸ Chapter 7-Sources of Finance (Raymond James Ltd 2020) 8 <<https://www.raymondjames.ca/canadian-preferred-shares-report>> accessed on 18 March 2021

¹⁴⁹ Johnathan Korchak, (n 144)

¹⁵⁰ ibid

preference shares allow the holders to share surplus profit if any.¹⁵¹ Redeemable preference shares which stipulate a fixed date for redemption have a fixed date for repayment of initial capital.¹⁵²

3.4.2. Disadvantages of Preference Shares

A. Disadvantages for the Company

Costly than debt: The cost of raising capital through preference shares is higher than debt.¹⁵³ The higher risk preference shareholders take makes them to expect a higher return as a compensation for the risks attached to them when compared with debt.¹⁵⁴ Besides, the interest on debt is tax deductible while preference dividend is not deducted as an expense for the purpose of calculating income tax.¹⁵⁵ However, the tax treatment of preference dividend varies from jurisdiction to jurisdiction. Some countries provide a favorable tax treatment for preference dividend and hence in such situations the tax treatment of preference dividend will be an advantage for the company. For instance, in Canada preference dividend have a tax credit and this makes them more tax efficient than debt since the interest on debt is fully taxed in Canada.¹⁵⁶

Financial Burden: in case of cumulative dividend arrears of dividend will be a permanent burden for the company unless it is redeemable. Usually, most of the preference shares are cumulative; it would have the tendency to increase the financial burden of the company.¹⁵⁷ The company may also be compelled to decrease profits of ordinary shareholders with a view to pay to preference shareholders.¹⁵⁸

B. Disadvantages for the Investor:

¹⁵¹ *Business Finance* (Shivaji University Distance Education Book 2018) 78

¹⁵² *ibid*

¹⁵³ Denzil Watson and Antony Head, (n 105)

¹⁵⁴ Chapter 7-Sources of Finance, (n 148)

¹⁵⁵ *ibid*

¹⁵⁶ Chapter 7-Sources of Finance, (n 148)

¹⁵⁷ Deepti Verma, (n 156)

¹⁵⁸ *ibid*

Higher risk than debt: Preference shareholders are paid if the company is profitable; there is no guarantee of Payment.¹⁵⁹ This makes them risky and less attractive for the investor. However, loss of accumulated arrears of dividend is not a problem for cumulative preference shareholders.¹⁶⁰

Absence of voting right: Since preference share is usually non-voting the role, they play in the management of the company is very limited and hence they have no guarantee over the assets of the company.¹⁶¹

Entitle only a fixed dividend: Unless the preference share is participatory preference share, preference shareholders are not entitled to any surplus profit of the company.¹⁶² This makes preference shareholders in a disadvantages position in case the company gets higher profit.

3.5. Role of Preference Shares in corporate Finance

3.5.1. Concept of Corporate Finance

Every company needs capital to start, operate, expand and develop its business.¹⁶³ Nowadays, finance is becoming a key to run a business, without it no business is possible. It is an integral part of the business itself which is required in every part of a business activity.¹⁶⁴ Finance is required in all types of corporations regardless of their size whether large, medium or small organizations engaged either in the industrial sector, service sector or in trading activity.¹⁶⁵ However, the amount of capital required may vary based on the size and nature of the business.

Corporate finance is all about financial issues of a corporation. It involves decisions on how and where to raise capital, how to employ, manage and control the capital so as to achieve the goal of the company. A company may raise capital from different sources, equity and debt being the

¹⁵⁹ Denzil Watson and Antony Head, (n 105) 111

¹⁶⁰ *ibid* 112

¹⁶¹ Deepti Verma, (n 139)

¹⁶² M.Muthumani, Financial Management Course Material, Sasurie College of Engineering 76

¹⁶³ A. Tondhlana, *Corporate Finance Module* (CUAC 207, Chinhoyi University of Technology 2017)2

¹⁶⁴ M.Muthumani, (n 162) 9

¹⁶⁵ *ibid*

most commonly used sources of corporate finance.¹⁶⁶ Corporations can raise capital by offering ordinary shares to the public in return for an ownership interest in the corporation.¹⁶⁷ Investors who buy the ordinary shares will be entitled to control economic rights within the company.

In debt the corporation borrows capital and agrees to pay back the debt on a definite date in the future.¹⁶⁸ The corporation is obliged to pay a fixed rate of interest throughout the duration of the debt.¹⁶⁹

Preference shares with their unique characteristics can also be an important source of finance for corporations. Its unique characteristics emanates from the hybrid nature of preference shares, i.e., share some of the characteristics of both equity and debt. They offer a lot of flexibility in transaction structuring and hence they are very attractive. Note that preference shares are different from preferential issue of shares.

3.5.2. Preference Shares as an alternative source of corporate Finance

Within an enabling legislative framework, corporations usually have a variety of options to raise capital, equity and debt securities being the dominantly used.¹⁷⁰ Preference shares represent an alternative source of capital for corporations that are offered to the public in a similar way with ordinary shares, but have their own peculiar features.¹⁷¹ They have both the characteristics of debt and equity and hence called as a hybrid instrument.¹⁷² They also differ from ordinary shares in that they give at least one or more preferential rights to their holders.¹⁷³ These unique features combined with a cumulative dividend, participatory and convertibility features make preference shares attractive and important alternative securities for companies in need of finance.¹⁷⁴

¹⁶⁶ Christopher Girdler, 'A Guide to Preferred Shares' (A Special Report by the Portfolio Advisory Group, CFA 2018)3

¹⁶⁷ *ibid*

¹⁶⁸ *ibid*

¹⁶⁹ *ibid*

¹⁷⁰ Christopher Girdler, (n 166)

¹⁷¹ *ibid*

¹⁷² Tatia Bachvaia, (n 21) 3

¹⁷³ *ibid*

¹⁷⁴ *ibid*

Early justification for the use of preference share is its attractiveness for firms in financial difficulties.¹⁷⁵ This attractiveness comes from the flexible feature of preference shares when it comes to payment of dividend.¹⁷⁶ Absence of risk of bankruptcy as a result of delay of payment of preference dividend is important incentive for corporations to issue preference shares.¹⁷⁷

The tax incentive of debt security is irrelevant for companies undergoing through a decreased existing income record and for those with negative future expected income.¹⁷⁸ In such occasions issuing ordinary shares is not the best alternative since it's likely that they may be underpriced in such situations.¹⁷⁹ Issuing preference shares becomes more favorable than ordinary shares in order to avoid the problem of selling ordinary shares with a low price and retain the control of existing shareholders over the company. Generally, preference shares are favorable alternative securities to raise capital for companies in higher bankruptcy risk, low current and future expected income.

Preference shares are also more favorable than debt securities to maintain a balanced capital structure and debt capacity of companies.¹⁸⁰ The debt to equity ratio is the usually used matrix to measure the financial status of corporations.¹⁸¹ Preference shares are considered as net worth of a company and hence issuing preference shares instead of debt finance decreases the debt to equity ratio of a company.¹⁸²

When compared to ordinary shares, preference shares are cheaper alternative securities to raise capital.¹⁸³ Additionally, providing preference shares as an alternative security widens the capital market and helps companies “to take advantage of favorable market conditions”.¹⁸⁴ Adding access to additional investors is the other incentives of issuing preference shares.

¹⁷⁵ Chuk-Yan Wong, ‘Preferred Stock Financing’ (A Thesis Submitted in Partial Fulfilment of the Requirement for the Degree of Masters of Science in Business Administration, The University of British Columbia 1989)2

¹⁷⁶ *ibid*

¹⁷⁷ *ibid*

¹⁷⁸ *ibid* 25

¹⁷⁹ *ibid*

¹⁸⁰ *ibid* 16

¹⁸¹ Preference Shares: Types, Features and Advantages, (n 140)

¹⁸² *ibid*

¹⁸³ Kevin J. Horan, ‘The ABCs of U.S. Preferred’ (2017), S&P Dow Jones Indices: A division of S&P Global 1

¹⁸⁴ Chuk-Yan Wong, (n 175) 16

3.5.3. Role of Preference Shares in Start-Ups

Every new business requires finance. Entrepreneurs only have ideas and dreams until they acquire the necessary capital to begin their business. They may not have sufficient capital to finance their company on their own and may look for external financing.¹⁸⁵ Many of the entrepreneur's face challenges in selecting the source of finance for their business. As shown above debt and equity financing are the dominantly used sources of business finance. However, both of them have their own disadvantages. Financing through debt allow to control and own one's company, but it will be a permanent financial burden. Even if startups choose debt financing, they may not be able to access their financial instrument due to various reasons. Firstly, they may be required to charge certain asset as a guarantee for the repayment of their debt. Certain minimum capital requirement may also be required to obtain debt. Besides, financial institutions may not be willing to take the extreme risks attached to startups.¹⁸⁶

Equity financing is an important source of business corporate finance; however, it requires you to give certain portion of the ownership interest to the equity holder.¹⁸⁷ But, the entrepreneurs may not want to surrender the control rights to outside investors in order to achieve their long-term plan. Besides, they are costly financial instruments. Although, entrepreneurs are willing to take their companies public investors may not be interested to invest in these risky businesses.¹⁸⁸ Therefore, the companies need securities which meet the interests of both investors and the company.

Financing through preference share issuance mitigate the drawbacks of both debt and equity financing and play an important role in the financing of start-ups.¹⁸⁹ The flexible nature of preference shares also allows companies to provide terms and conditions which are more favorable for them and investors in order to attract investment.

There are investors called venture capitalists who invest in risky startup companies by providing financial support and preference shares are important investment engines for these venture

¹⁸⁵ Tykvova Tereza, 'What do Economists Tell Us About Venture Capital Contracts?' (2000) ZEW Discussion Paper No.00-62 1 <<http://hdl.hundel.net/10419/24410>> accessed on 18 March 2021

¹⁸⁶ *ibid*

¹⁸⁷ *Business Finance*, (n 151) 7

¹⁸⁸ *ibid*

¹⁸⁹ *ibid*

capitalists.¹⁹⁰ Venture capitalists take a high financial risk while they invest in startups and hence, they require certain privilege over ordinary shareholders.¹⁹¹ This can be arranged through the issuance of preference share for venture capital companies.

Though, the concept of venture capital investment is not as such practicable in our Country, this investment has been increasingly used in countries where the capital market is well developed, particularly, in the USA.¹⁹² This fact led us to the conclusion that preferred share is great investment opportunity for new highly risky startup companies.

Startup investment is the key tool for reducing unemployment rate and promoting entrepreneurship and innovation which in turn positively impact the development of countries.¹⁹³ Several studies reveal the positive impact of innovative startup firms on economic growth.¹⁹⁴ As a result, policy makers nowadays are more concerned on the need to support startup and venture capital activity.¹⁹⁵ Identifying and understanding problems inherent in venture capital investment is the first important step in the move to create friendly environment for startup firms.¹⁹⁶ As noted earlier, investing in startups is highly risky and hence investors may require certain privilege and this can be achieved through preference share arrangement which is flexible enough to accommodate the interests of both the investors and the firms.

Many of the large corporation such as Google, Facebook, Amazon, Apple have used this model of financing in their initial public offering and this fact have motivated startup companies to use venture capital financing.¹⁹⁷ Thus, preference shares are not only used by large corporations but also by startup companies who need capital to enter the market or additional funding for their business.¹⁹⁸ To sum up, preference share is an important investment vehicle for both small and large corporations to achieve their long-term business goals.

¹⁹⁰ Charles Korsmo, (26) 1164.

¹⁹¹ Assefa Aregay, 'Preferred Shares Under Ethiopian Company Law: The Ignored Vehicles of Corporate Finance' (2016-17) 28 (61) *Journal of Ethiopian Law* 65

¹⁹² Tatia Bachvaia, (n 21) 41

¹⁹³ Tykyvoa Tereza, (n 185)

¹⁹⁴ *ibid*

¹⁹⁵ *ibid*

¹⁹⁶ *ibid*

¹⁹⁷ *ibid*

¹⁹⁸ *ibid*

CHAPTER FOUR

EXAMINING THE LEGAL AND PRACTICAL DIMENSIONS OF CLASSES OF COMPANY SHARES IN ETHIOPIA

4.1. The Legal Dimension of Classes of Company Shares in Ethiopia

4.1.1. Company Shares under the Ethiopian Company Law

Companies limited by shares are expressly recognized and regulated under the Ethiopian Commercial Code. However, the term “company share” is nowhere defined. Article 304 of the Commercial Code defines share company as “...a company whose capital is fixed in advance and divided in to shares...”. This definition of a share company connotes share as a definite portion of the capital of a company. But this definition does not adequately reflect the nature of company share. Neither is it a definition of a “share”. A similar provision is provided under article 245 of the Draft Commercial Code. The draft does not come up with different provisions on the issue of share in general and classes of shares in particular and hence the corresponding provisions of the draft Commercial Code are cited in the footnote.

As noted earlier, shares confer different right to their holders which may be voting right, dividend right; return of capital upon winding up of a company, right to subscription of newly issued shares. Similarly, in the Ethiopian company law, shares are conferred with different rights. Every share contains an entitlement to an annual dividend and a right to get a share in surplus asset if any upon winding up of a company.¹⁹⁹ These entitlements to profit and surplus asset are in proportion to the shares held by them unless it is stipulated to the contrary either in the memorandum or articles of association.²⁰⁰

The other important right acquired by holding a share of a company is voting right.²⁰¹ When it comes to voting right of shareholders under the Ethiopian company law regime, it seems to follow the principle of equal share equal vote. In principle, every share confers voting right save for the case of preference shares where voting right may be restricted.²⁰² As per article 336(3) of

¹⁹⁹ Commercial Code, Art 345(1); Draft Commercial Code, art 291(1)

²⁰⁰ *ibid* art 345(2); art 291(2)

²⁰¹ *Ibid* art 345(30); art 291(3)

²⁰² *ibid* art 336(3); art 279(3)

the Commercial Code, preference share also confers voting rights to their holders; however, this right can be restricted by expressly providing either in the memorandum or articles of association. But shares with restricted voting right shall not exceed half of the total capital.²⁰³ Prior right to subscription of shares upon an increase of capital is the other important right obtained from owning a share of a company in Ethiopia.²⁰⁴ Shareholders have a prior right to subscribe newly issued shares in proportion to their share in the company.²⁰⁵

4.1.2. Classes of Company Shares under the Ethiopian Company Law

Like in many other jurisdictions, the Ethiopian Commercial Code permits companies to issue different classes of shares which confer different rights to their holders.²⁰⁶ Companies may provide different classes of company shares at the time of establishing their company by expressly providing it in either the memorandum of association or by amending the memorandum by general resolution in order to allow the issuance of different classes of shares.²⁰⁷ Article 335 of the Commercial Code provides the possibility of issuance of several classes of shares having different set of rights. However, three classes of shares are expressly provided in the commercial code, i.e., ordinary shares, preference shares and dividend shares.²⁰⁸

Shares of the same class shall have the same par value and the same rights.²⁰⁹ A change in the rights conferred on a certain class of shares will not be valid unless the classes of shareholders consented to the change in the same way as general shareholders' meeting does.²¹⁰ Further, article 426 of the Commercial Code requires approval by the special meeting of a class of shareholders whose right is intended to be altered for effective variation of class right. However, what constitutes class of share and class right is nowhere defined under the Commercial Code.

²⁰³ *ibid* art 336(4); art 279(4)

²⁰⁴ *ibid* arts 345(4) & 470(1); arts 291(4) & 448(1)

²⁰⁵ *ibid*

²⁰⁶ *ibid* art 335(1); art 278(1)

²⁰⁷ *ibid*

²⁰⁸ *ibid* arts 335-37; arts 278-80

²⁰⁹ *ibid* art 335(2); art 278(2)

²¹⁰ *ibid* art (335(3); art 278(3)

Ordinary shares

Ordinary shares are the most commonly issued classes of shares. Ordinary shares are not expressly provided in the Commercial Code. However, this does not mean that they are not regulated by the Commercial Code. As noted earlier, shares of a company are presumed to be ordinary shares unless a contrary stipulation is provided either in the memorandum or articles of association. Ordinary share confers a right of dividend when declared and a right to a return of capital upon winding up of the company.²¹¹ The amount of dividend and capital return is in proportion to the shares held by the shareholders.²¹²

Every share confers voting right on their holders.²¹³ As per article 407(2) every share carries at least one vote. This is in line with the provision of article 389(2) which stipulate voting right as an inherent right of shareholders. Further article 410 strictly prohibits any restrictions in exercising voting right. Thus, from the cumulative reading of these provisions one can certainly conclude that all shares including ordinary share carry voting right. Ordinary shareholders have voting right in proportion to the amount of capital invested.²¹⁴ Though voting right is an inherent right of shareholders it may be limited by either the memorandum or articles of association as far as the limitation is equal for all shareholders irrespective of their share class.²¹⁵

Prior right to subscribe newly issued shares upon increase of capital in proportion to the number of shares is the other right conferred on ordinary shares.²¹⁶

Preference Shares

The right conferred on preference shareholders is determined by a memorandum of association or terms of issue and hence vary from company to company. As globally understood preference shares have no legal definition and what constitutes preference share is known by referring to the constitutive document of a company or by the decision of the concerned body of the issuing company.²¹⁷

²¹¹ *ibid* art 345(1); art 291(1)

²¹² *ibid* art 345(2); art 291(2)

²¹³ *ibid* art 345(3); art 291(3)

²¹⁴ *ibid* art 407(1); art 383(1)

²¹⁵ *ibid* art 408; art 384

²¹⁶ *ibid* arts 345(4) & 470(1)

²¹⁷ Assefa Aregay, (191) 73

The Commercial Code, in article 336 permits companies to issue preference shares either by expressly providing it in the memorandum of association or by a resolution of the extraordinary general meeting of shareholders. Preference shares have priority or preferred right over other classes of shares. The preference rights may be priority right to subscribe newly issued shares, preference as to dividend or priority on the distribution of surplus asset upon winding up of the company or both priorities to receive dividend and surplus asset. The list in sub article one of article 336 is illustrative and hence other preference rights can be created by the memorandum of association or by the resolution of extraordinary general meeting. However, preference shares which confer preference on voting right are prohibited.²¹⁸

In principle preference shares confer voting right on their holders and this right can be limited by the memorandum of association.²¹⁹ Thus, preference shareholders may or may not have the right to vote at shareholders' general meetings depending upon the provisions of the memorandum of association of companies, but they may vote at the extraordinary meetings.²²⁰ However, preference shares which limit voting right shall not exceed half of the total capital invested in the company.²²¹

When we carefully look at the recognition of preference shares in the Commercial Code it seems like that preference shares do not confer crucial preferential rights than those conferred by ordinary shares. Let us look at rights provided in article 336(1) one by one. The provision is read as: "... Such shares enjoy a preference over other shares, such as a preferred right of subscription in the event of future issues, or rights of priority over profits, or assets or both."²²²

“Preferred right of subscription”

As quoted above preference share may confer priority right of subscription of new shares issued by a particular company. Article 336(1) seems to have considered priority over subscription of preference shares as a preferred right conferred upon preference shares when expressly provided

²¹⁸ Commercial Code, art 336(2); art 279(2)

²¹⁹ *ibid* art 336(3); art 279(3)

²²⁰ *ibid*

²²¹ *ibid* art 336(4); art 279(4)

²²² *ibid* art 336(1); art 279(1)

in the memorandum of association. However, article 345(4) of the same code provides preferred right of subscription as a right of every shareholders. As per this provision both preference and ordinary shareholders have a right to subscribe new shares issued upon increase of capital in priority to outside investors. This provision guarantees the prior subscription right of all shareholders against outside investors. From this interpretation it sounds right if we conclude that prior right of subscription provided under article 336 is applicable among the existing shareholders. However, article 475 prohibits the issuance of documents which entitle prior right of subscription. What kinds of documents are prohibited in this provision? How the word 'document' is interpreted determines whether prior right of subscription is among the package of rights conferred to preference shares.

“Priority over Profits”

Priority as to dividend right is one of the rights usually conferred upon holders of preference shares. Article 336(1) of the Commercial Code also provides dividend priority as a right conferred on preference shares if expressly provided in the memorandum of association. As per the cumulative reading of articles 345(1) & 389(2) the right to dividend is a right inherent in membership and it is a right of every shareholder and hence is not a right conferred only on preference shareholders. What makes preference shares preferable over ordinary shareholders is with regard to priority, i.e., preference shareholders are entitled to payment of dividend before or in priority to ordinary shareholders. Priority over profit is the only preference of preferred shareholders over other shareholders which are provided under article 336 of the code. As noted in the previous chapter one of the basic feature of preference shares is that usually they confer fixed or predetermined dividend, this feature of preference share is not reflected in article 336 of the code which is the only article expressly and specifically provided for preference dividend. Of course, most of the terms of preference shares are based on the agreement between the investor and the company and as noted earlier setting a variable rate of preference shares has also become common in recent days. However, when we look at preference shares in Ethiopia, the law is not flexible enough to provide terms which are favorable to both the investor and the company and are not attractive to investors.

In case the company declares dividend all the shareholders are entitled to receive dividend in proportion to their shareholding unless a contrary stipulation is provided either in the

memorandum or articles of association of the company.²²³ It seems sub article two of article 345 provides for the possibility of entitlement to unequal dividend right if provided either in the memorandum or articles of association. However, the law hasn't made it explicit the situation whereby a company is permitted to entitle different dividend to shareholders. On the other hand, article 310(1) provides situations where founders may be entitled to a special share in the profit in addition to their claim as shareholders.

“Priority in Surplus Asset”

An entitlement to any surplus asset in priority to other shareholders upon winding up is the other preference right recognized by the Commercial Code. This preferential right put preference shareholders in a better position than ordinary shareholders. However, this preference is not also attractive for investors since bankruptcy will be declared when the liabilities of the company exceed that of its asset. Preference shareholders will be paid if there would be surplus asset after creditors are paid.

Dividend Shares

Dividend shares are one of the expressly recognized classes of shares under the Commercial Code. They are created when the company repays the par value of a share to their holders.²²⁴ A company issue dividend shares for those shareholders whose shares have been redeemed.²²⁵ A company is allowed to redeem shares out of the profits or from reserve funds of the company, without capital reduction.

Dividend shares do not entitle to a dividend which represents a statutory interest as well as a return of contribution upon winding up, however, they entitle a dividend exceeding the statutory interest and a right to share surplus asset if any upon winding up unless a contrary is provided in the memorandum of association.²²⁶ They also retain voting right.²²⁷

²²³ *ibid* arts 345(2) & 389(2); art 291(2) & 363(2)

²²⁴ *ibid* art 337(1); art 280(1)

²²⁵ *ibid* art 337(2); art 280(2)

²²⁶ *ibid*

²²⁷ *ibid*

4.1.3. Limitations of the Ethiopian Law in Recognizing Varieties of Classes of Company Shares

Though the Commercial Code expressly permits companies to issue different classes of company shares, there are limitations in expressly recognizing variety of shares. Article 335 of the Code allows companies to issue different classes of shares which confer different rights to their holders. Subsequent articles expressly recognize preference shares and dividend shares. This may raise a question as to whether the classes of shares permitted by article 335 are limited to those expressly recognized in the Commercial Code (i.e., preference shares and dividend shares) or are Ethiopian companies permitted to issue different classes of shares other than dividend and preference shares. Is article 335 of the Commercial Code referring to the possibility of issuing different classes of ordinary shares or is it referring to classes of company shares in general? It seems that preference shares and dividend shares provided under article 336 and 337 of the Code are reflecting or explaining article 335 of the same Code. If that is the case, companies in Ethiopia are only allowed to issue preference and dividend shares in addition to ordinary shares. Issuing founder share is expressly prohibited as provided in sub article three of article 310 of the Commercial Code.

There are different classes of company shares which are not recognized in Ethiopia like employees' shares, different classes of ordinary shares. Shares which restrict as well as give preference as to voting are prohibited by the Commercial Code. Save preference shares, every share confers voting rights to their holders and thereby the Commercial Code prohibits companies from issuing non-voting shares. Here a question may be raised on the case of employee's shares? Employees' shares as noted earlier are usually non-voting. So, are Ethiopian companies permitted to issue non-voting shares to their employees? As per the existing Commercial Code companies are not able to do that because the law has restricted the possibility of issuing non-voting shares only in case of preference shares.

4.1.4. Restrictions on Bank and Insurance Share Companies

The Banking Business Proclamation and the Insurance Business Proclamation prohibit banks and insurance companies from issuing different classes of company shares and hence the Commercial Code provisions on classes of company shares are not applicable to banks and

insurance companies.²²⁸ Thus, banks and insurance share companies in Ethiopia are allowed to issue only ordinary shares. However, in Canada the popular issuers of preferred shares are Banks and Insurance in addition to the telecom sector.

The prohibition of different classes of shares in the financial sector results from the stringent regulations the country follows in the financial sector. So, the prohibition is seen from regulation perspective, dominance by few shareholders is not desired in this sector.²²⁹ The restrictions in shareholding of a bank not to exceed 5% of the capital of a company and the regulations on influential shareholder clearly show the law's intentions to prohibit dominance in the financial sector.²³⁰ These stringent regulations are meant to protect the interest of depositors.²³¹

4.2. The Practical Dimension of Classes of Company Shares in Ethiopia

Nowadays the number of share companies formed through public subscription of share is increasing.²³² Though the Commercial Code permits Ethiopian companies to issue different classes of company shares which confer different rights to their holder, variety of share is not seen practically. Ordinary shares are the only and the ones in use.

Classes of shares issued by companies are among the details which need to be provided under the memorandum of association of the respective companies.²³³ The memorandum of association of companies shall be authenticated by the concerned organs in Ethiopia. Three governmental authorities have a direct concern on the issue at hand, i.e., Document Authentication and Registration Agency, Ministry of Trade and Industry and the Ethiopian Investment Commission. The agency is the principal authority mandated with the responsibility to authenticate documents in general and memorandum of association in particular.²³⁴ The Ministry authenticates

²²⁸ Banking Business Proclamation, (2008) Proc.No. 592, Fed.Neg.Gaz. 4th year No. 57, art 10(1); Insurance Business Proclamation, (2012) Proc.No.764,Fed.Neg.Gaz. 18th year No. 57, art 11(1)

²²⁹ Interview with Muluken Mehertu, Senior Expert, National Bank of Ethiopia, (Addis Ababa, 10 May 2021)

²³⁰ *ibid*

²³¹ *ibid*

²³² Assefa Aregay,(191)62

²³³ Commercial Code, art. 313(6); 255(6)

²³⁴ Authentication and Registration of Documents Proclamation, (2015) Proc.No.92, Fed.Neg.Gaz. 22th year No.39, art 9(1)(c)

memorandum of association through delegation from the Agency.²³⁵ The Investment Commission also authenticates memorandum of association for investors it has issued an investment permits as a part of one stop service.²³⁶ The researcher has approached all these three institutions in order to understand how classes of company shares are practiced in Ethiopia. The agency and the Investment Commission responded that they have never come in contact with a memorandum of association containing different classes of company shares.²³⁷ The document authentication practices in the ministry do not let them to know whether different classes of company shares are used by Ethiopian companies or not. The Ministry checks the appointment of manager and address and the fact that the memorandum is not contrary to law and morality while authenticating memorandum of association of companies. There is no practice of checking class of shares.

Though these three authorities are the principal organs who come in to direct contact with the issue at hand, the fact that these institutions told us that there is no the practice of issuing different classes of shares does not make us to reach the conclusion that classes of shares are never used in Ethiopia. Rather the writer of this paper prefers to conclude that there is no empirical evidence on whether classes of company shares are practically in use in Ethiopia. From the observations and interviews conducted to research the practice of classes of company shares I have understood that classes of shares in general and preference shares in particular are not well known and used in the market and their usage is not encouraged. This results from a number of different factors.

Lack of Awareness: majority of the interviewees in this paper argue lack of knowledge as one of the factors that hinders Ethiopian share companies from issuing different classes of company shares. The fact that the Commercial Code provisions are imported from abroad creates a challenge in understanding and utilizing concepts like classes of company shares.

²³⁵ Interview with Menur Mohammed, Branch Manager, Document Authentication and Registration Agency (Addis Ababa, 9 April 2021)

²³⁶ Investment Proclamation, (2020) Proc.No. 1180, Fed.Neg.Gaz, 26th year No. 28, art 24

²³⁷ Interview with Menur, (n 235); Ahmednur Yusuf, License and Registration Directorate Director, Ethiopian Investment Commission (Addis Ababa, 13 April 2021)

Legal experts in Ethiopia have a suspicion on whether the different classes of company shares are understood even by government authorities who have a direct concern on the issue at hand like the Ministry of Trade and Industry, Document Authentication and Registration Agency and the Investment Commission.²³⁸ This suspicion is not without reason; there were cases where memorandums of associations containing preference shares are rejected by DARA. Mr. Yonas who has been working in Mesfin Tafesse and Associates law office for four years told me that he has never seen an investor who has been successful in registering a memorandum of association containing different classes of shares. The writer of this paper asked Mr. Yonas if there are cases where the investors appeal to higher officials, he said never because they trust the experts there more than the lawyer's advice. Ato Menur, a manager at the head office of DARA also confirmed this fact by saying that they have never come in contact with issues related to classes of shares.

The administrative problems which result from lack of awareness is one of the factors that discourage the issuance of preference shares. As a result, the legal experts in Ethiopia don't encourage investors to use different classes of shares. Of course, the researcher has observed this lack of awareness and understanding by these institutions while conducting the research. Even there is less awareness on the use of different classes of shares like preference shares as an important corporate finance vehicle. The Ministry of Trade and Industry authenticate memorandum of association but, the experts do not check whether the shares provided in the memorandum are of only the same class or of different classes of company shares.²³⁹ Though, these institutions have a direct concern on classes of company shares the concept is not familiar among the employees. So, let alone the business persons, also the authorities lack a clear understanding of the concept. Thus, the authorities responsible for authenticating memorandum are not in a position to register classes of shares with special features.²⁴⁰ As a result, it becomes difficult to get empirical evidence on the practice of classes of company shares in Ethiopia.

²³⁸ Interview with Getu Sheferaw, Lawyer, Mehrteab Leul and Associates Law Firm (Addis Ababa, 12 April 2021); Deborah Haddis, Associates, Mesfin Tafesse and Associates Law Firm (Addis Ababa, 13 April 2021); Yonas Mulatu, Legal and Compliance Manager, Heineken Breweries Share Company, former Associates at Mesfin Tafesse and Associates Law Firm, (Addis Ababa, 23 April 2021)

²³⁹ Interview with Embet Asefa, Trade and Registration and Licensing Team Leader, Trade Registration and Licensing Directorate, Ministry of Trade and Industry, (Addis Ababa, 8 April 2021)

²⁴⁰ Interview with Yonas, (n 238)

Socio-Economic Development: doing business in an organized company form does not have a long history in Ethiopia.²⁴¹ The status accorded to trading activities by the Ethiopian societies was mentioned as one of the contributing factors for this fact.²⁴² It was in 1897 that Ethiopia's first company was established which is a railway company. Different other companies were also established in the period between the end of 19th century and at the beginning of the 20th century.²⁴³ Then after significant changes were introduced during the regime of Emperor Haile Selassie, i.e., the enactment of laws in 1933 like company law, bankruptcy law, etc., and other investment incentives along with governance transformations have increased the economic participation of the private sector.²⁴⁴ Stock trading was also started during this period.²⁴⁵

However, the development of the private sector was not able to continue for long as a result of the overthrow of the Imperial Regime by the Derg who followed the ideology which discourage the development of the private sector.²⁴⁶ As a result, the private sector was stagnant until the Derg regime was overthrown by the Ethiopian People's Revolutionary Democratic Front (EPRDF). Though this regime has declared capitalism, the move to the private sector was not prompt.²⁴⁷ It is in the last two decades that the private sector has started to enter the market.²⁴⁸ Even if majority of the share companies in Ethiopia are family-owned businesses, recently the number of companies formed through public subscription of shares is relatively increasing. However, there is no empirical evidence on the issuance of different classes of company shares by Ethiopian companies. This may be attributable to the fact that majority of the companies successfully established through public subscription of shares are financial institutions and the financial institutions in Ethiopia are restricted from issuing different classes of shares.²⁴⁹ Lack of formal market for trading share or absence of stock market is also the other potential reason for lack of the practice of different classes of company shares in Ethiopia.

²⁴¹ Fekadu Petros, *Ethiopian Company Law* (2nd edn, Far East Trading PLC Publisher, Addis Ababa 2015) 33

²⁴² *ibid*

²⁴³ *ibid*

²⁴⁴ *ibid*

²⁴⁵ Interview with Getu, (n 238)

²⁴⁶ *ibid*

²⁴⁷ *ibid*

²⁴⁸ *ibid*

²⁴⁹ *ibid*

Lack of the Habit of working together: the Ethiopian society does not have a habit of doing business together.²⁵⁰ People in Ethiopia usually engage in business activities either individually or with family members and close friends. When they choose to undertake a business activity in a company form, they usually form private limited companies with either family members or close friends. This makes the majority of Ethiopian companies to be private limited companies. There are about 67,878 registered private limited companies while the number of share companies is 2278.²⁵¹

Nowadays, the number of share companies in Ethiopia is increasing, however, majority of them are again family-owned share companies and they are closed to the public. They don't need to add outsiders for fear of the consequences arising from adding non-family members like conflict on the management of the company.²⁵² When additional finance is required these companies borrow from banks.²⁵³

No habit of using new concept: Companies in Ethiopia have no a habit of providing different rights and obligations than those already provided by others under their memorandum of association.²⁵⁴ What is practiced in Ethiopian companies is to copy the memorandum of association provided by others only by changing the name of the company, members, address allocation of shares and other private details.²⁵⁵ There is no habit of changing the governing rules of the company and thus the governing rules of Ethiopia companies are almost similar.²⁵⁶

Absence of the practice of Variety of classes of Shares: the fact that different classes of company shares are not issued in Ethiopia discourages particularly foreign investors from using

²⁵⁰ *ibid*

²⁵¹ Data from the Ministry of Trade and Industry, note that this number varies day by day (12 April 2021)

²⁵² Interview with Tophic Meki, Manager, Wabi shebela Hotel Share Company (Addis Ababa, 9 April 2021); Haile W/geyorgies, Deputy Director General, Faffa Food Share Company (Addis Ababa, 16 April 2021)

²⁵³ *ibid*

²⁵⁴ Interview with Menur Mohammed, (235)

²⁵⁵ *ibid*

²⁵⁶ *ibid*

different classes of shares.²⁵⁷ Foreign investors come from countries where the capital market is well developed and there are investors who ask for different classes of shares, particularly preference shares. However, when they are told that it is not in existence in Ethiopia despite its clear recognitions in the law, the investors don't want to be the first to introduce them.²⁵⁸ The lawyers even don't encourage them to use different share class structure because they don't want to face challenges because of the fact that they don't know how the Ethiopian regulators respond to the issue.²⁵⁹ In fact, the regulators cannot forbid investors from issuing different classes recognized by the Commercial Code, but the lawyers have a suspicion on the understanding of the regulators and hence they don't want to take risks.²⁶⁰

The fact that classes of shares are not practiced is also a challenge, because it will raise procedural questions.²⁶¹ Procedural rules as well as detail rules are not yet provided as a result of inexperience of use of different classes of company shares in Ethiopia.²⁶² In general, the lawyers mentioned that there are clients who ask for different classes of shares, but what discourages them from using it is the absence of the practice.

Limitation in the Law

Even if preferred stocks are regulated by the Ethiopian law, the provisions are neither flexible nor do the provisions in the commercial code meets the expectation and needs of investors. As discussed earlier, the Commercial Code do not give rights better than ordinary shareholders. Unless the law governing classes of shares is made up to date and flexible, there is little chance that investors will prefer this mode of investment and investors also lack interest to invest in a particular market.

²⁵⁷ Interview with Getu, Deborah and Yonas, (n 238)

²⁵⁸ *ibid*

²⁵⁹ *ibid*

²⁶⁰ *ibid*

²⁶¹ Interview with Deborah, (n 238)

²⁶² Interview with Menur, (n 235); Yonas, (n 238+)

Investors in Ethiopia invest in companies by seeing the profile of the company like its business idea and profitability.²⁶³ There is the practice of offering preference shares from both the side of the company and investors.²⁶⁴ From the side of the company preference shares is not as such attractive particularly for large and profitable companies since preference dividend is costly than the legal interest on debt.²⁶⁵ However, for companies who are in need of working capital and who are not able to get debt finance the role of preference share as a corporate finance tool shall not be underestimated.

As said earlier, preference share as provided by the Commercial Code is not attractive to the investors. They don't confer rights better than ordinary shares. For instance, in England preference shares confer governance rights like participation in the management of the company, the right to be consulted in important decisions and right to preferred financial rights.²⁶⁶

²⁶³ Interview with Eleni Kebede, Law and Share Affairs Manager, Habesha Cement Share Company (Addis Ababa, 10 May 2021)

²⁶⁴ *ibid*

²⁶⁵ *ibid*

²⁶⁶ Introduction of Preferred Shares in France (2004) Jones Day Commentaries 1

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

The main goal of this paper is to examine the legal and practical dimensions of classes of company shares in Ethiopia. Though their use is still subject to debate, issuing different classes of shares with, without voting or with multiple voting right is common especially in countries where the capital market is well developed. Despite the controversies and debates surrounding on the need to permit the issuance of different classes of shares in a company particularly on shares which confer different voting right, several countries have accepted the structure as an important corporate finance vehicle. Corporate law needs to be flexible enough to accommodate the needs and interests of investors. Even if the Ethiopian company law permits the issuance of different classes of shares basically the expressly recognized classes of company share in the Commercial Code are three, i.e., Ordinary shares, Preference shares and Dividend shares. Companies in Ethiopia save for bank and insurance companies can issue these three classes of shares. However, despite the recognition and regulation they are not used in practice. In fact, the provisions in the Commercial Code are not flexible to accommodate the needs and interests of both the investor and a company. Firstly, the Commercial Code has limitation in expressly recognizing different classes of company shares. Neither does the Commercial Code left the option to create different classes of company shares based on the specific needs of the company and the investor for them. Secondly, even if preference shares are recognized the provisions are neither flexible nor grant a better right than those granted by ordinary share. Thus, preference shares as provided under the commercial are not attractive both for the issuing company and the investor.

In spite of the limitations in the law, classes of company share are not experienced in Ethiopia. The concept is almost unknown in Ethiopia. Classes of company shares in general and preference shares in particular are in existence only in paper in Ethiopia. There is no even understanding on the use of Variety of classes of shares as an important corporate finance

engine. The concept is not well known by the experts responsible for authenticating memorandum of association and this leads to an administrative problem which discourages the issuance of different classes of company shares. The socio-economic development of the country is the other reason for lack of the practice of classes of company shares in Ethiopia. Lack of the habit of working together and absence of creating new concepts under the memorandum of association are also contributing factors for lack of the practice of classes of company shares in Ethiopia. People in Ethiopia copy paste a memorandum of association already prepared by others only by changing private details. Hence, there is no habit of providing different rights and obligations by providing different classes of company shares.

5.2 Recommendations

Based on the preceding discussions and conclusion the researcher recommends the following

- The first thing which needs to be carefully considered is an agreement on the need to permit companies to issue different classes of company shares in Ethiopia. All the stockholders shall be consulted and the law must have a clear legislative intent in regulating classes of company shares.
- Detail regulations and procedural rules are required to implement and use different classes of company shares in practice. Class of share, class right, variation of class right, activities and decisions which affect class rights like issuance of new class of share or for instance if a company issues preference share in a different round shall be clearly regulated. The grounds for creating classes of shares shall be clearly provided, why classes of shares? what special rights are conferred to a certain class of share? shall be made explicit. Protections to guarantee the implementation of rights of special shareholders is also required. In general, the regulatory capability in the trade sector shall be increased.
- The law must be flexible to accommodate the interests of both the company and the investor. The law either leaves the rights and duties provided in a class of share to be determined by both the investor and the company in order to provide terms favorable for them by considering all the circumstance of the case or preference shares shall be entitled crucial preferred rights than ordinary shares. Preference shareholders must be entitled to rights in excess to those traditionally conferred to shareholders in order to make them attractive and benefit both the company and the investor. Incentives and options are required to encourage people into business. Crucial rights used in other jurisdictions

like the right to nominate and elect directors and the right to influence important company decisions shall be introduced in our country. The successful use of these modes of investment in turn contributes for the development of the country when the companies become productive.

- Creating awareness to the business community and for government organs by providing seminars or any other options if any is the other task which needs to be undertaken by the government. For this to happen there shall be a responsible legal body mandated with the responsibility to create awareness, advise and encourage the business community to use different classes of company shares.
- Enhancing coordination and developing working together among the concerned organs, i.e., MoTI, DARA, EIC and Ministry of Revenue. This is required in order to avoid gaps and to smoothly implement the law on classes of shares and thereby create favorable conditions for the investor.
- Establishing formal market for trading shares is significant to offer different classes of shares. The researcher hopes that the planned stock market and the development of the private sector will open the door for the practical use of classes of shares in Ethiopia.

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