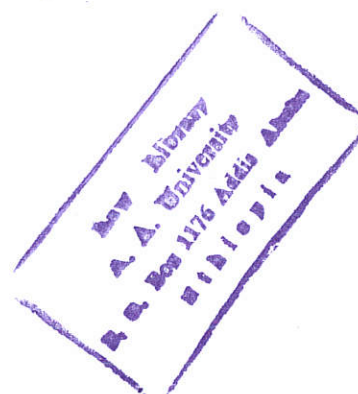


**Powers and Liabilities of Board of
Directors under Commercial Code
of Ethiopia: Law and Practice
(Partial Fulfillment for LL.M)**

By Kefene Gurmu



June, 2005

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES

APPROVED BY:
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ADVISOR

EXAMINER

EXAMINER

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Table of Continent

I. The Nature of a Company	1
A. Company defined	1
B. Salient features	9
1. Legal personality under commercial code of Ethiopia	9
2. Limited liability	12
a. Theoretical analysis	12
i) Company limited by shares	14
ii) Company limited by guarantee	15
b. Limited liability under commercial code of Ethiopia	16
i) Share company	17
ii) Private limited company	19
3. Constitution of the company: Brief historical background	21
a) Memorandum of association	23
b) Articles of association	25
Notes	27
II. Board of Director under Commercial code of Ethiopia	32
A. Board of directors defend	32

B. Qualification of directors	34
C. Appointment of directors	39
D. Board's meeting as a necessity of exercising power.....	42
Notes	47
III. Power of board of Directors.....	49
A. Division of powers of directors and general meeting	50
B. Powers of executive in relation to the board of directors	54
1. General manager	55
2. Managing director	55
a. Appointment of managing director	60
b. Removal of "managing director	60
C. Case analysis, regarding powers of board of directors ..	62
Notes	69
IV. Liabilities of Board of Directors	72
A. Civil liabilities	73
1. Liability to the company	73
a. Negligence	73
b. Breach of trust	75

c. Ultra vires	77
2. Liability to third party (creditors)	79
B. Criminal liability	80
1. False statement	81
2. Breach of trust	82
C. Actions against directors	82
1. Actions by the company	83
2. Actions by shareholders	84
3. Actions by creditors	87
Notes	88
V. Duties of Directors	91
A) Fiduciary duty	92
1. Competing with the company	92
2. Inside trading	94
B. Duty of care and skill	101
C. Duty to attend board meeting	103
D. Statutory duties	104
Notes	106
VI. Conclusion and Recommendation	108
Notes	118
Bibliography	119

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Introduction

This thesis is concerned with powers and liabilities of board of directors under the Commercial Code of Ethiopia. It deals with company that is managed by board of directors. Under Commercial code of Ethiopia, it is Share Company that is managed by board of directors.

It has seemed best to begin with the nature of company. Company in common law and continental legal system is examined company and partnership was also compared. Then company and partnership under the Commercial Code of Ethiopia are examined in the first chapter of this thesis.

Having the nature of a company in mind it is preferred to pass to the second chapter which deals with the concept of directorship under commercial code of Ethiopia.

The board of directors is the highest organ in the management of the company. Its powers emanate from the law and shareholders. Chapter three of this thesis deals with these powers.

Directors are obliged to exercise their power according to the powers conferred to them. If they deviate from these powers, they are liable to the company and third parties. These liabilities are dealt with in chapter four of this thesis.

Duties of directors are the most important elements which are closely related to powers and liabilities of directors. Duties of directors are discussed in the fifth chapter while the final chapter is remained for conclusion and recommendations.

I. The Nature of a Company

A. Company Defined

Company has been variously defined by different scholars, jurists and legislations. Justice John Marshal of USA defined company, as an artificial being invisible, intangible and existing only in the eyes of law.¹ Company for justice John Marshal is creation of law. Law brings company into existence and it is only law that do away with company. It exists and dies in the eyes of law but does not have material existence. The company being mere creation of law, therefore, posses what the charter of its creation confers upon it, either expressly or impliedly.

William A. Wood defined company as "an association of natural person or legally constituted persons authorized by law, separate and distinct from its stock holders [Shareholders] and in certain sense, is a citizen. Action at law may be obtained against it in the same way as against a natural person".²

For wood, company is an association of natural or legal persons. Association presupposes the existence of two or more persons. According to this definition one-person company is excluded. Wood said that company has its own citizen. Citizen in this sense is nationality. Nationality is a bond through which an

individual person relates to his country of origin.³ It is also true for a company to have its own nationality. The persons may be of different nationalities. But the company acquires the nationality of the country it is established. Members may change but the company remains. Members may sell their shares and leave the company, new members may buy a share and be members of the company but, the company remains with its nationality. Therefore according to Wood definition, nationality of a company is one of the necessary elements to be considered and should be done by giving the nationality of the country where the company is established without reference to its members. i.e. the company established in country 'A' with members from different countries acquires nationality of country 'A' and it is subject to the law of country A.

Another element of Wood's definition is that "Company is subject to law as a natural person does". Company as we will see latter on, is a legal person. Legal personality results in possession of property sue and are sued and have rights and duties. Company is a right and duty bearing organ equally as natural person is, but, it does not mean that natural person and legal person are one and the same. It is true that company comes into existence by operation of law but natural person comes into being by birth materially.

Company dies out through legal operation while natural person dies materially. What makes both natural and legal person the same is that both of them are right and duty bearing units. They are subject of law, own property, sue and be sued.

Another definition is definition given by justice Lindly. He said that the company is "an association of many persons who contribute money or money worth to common stock and employ it for common purpose".⁴

The strange term appears in this definition is "contribution in money or money worth"

Company is formed by two or more persons by pooling their resources and come to an agreement. The most important point is that members form their company by their contribution. Contributions are made to the amount of affordability by the members. On the other hand, the amount of share they own in the company is equal to their contributions. The extent of the liability of the member is also equal to the contribution made by the members. Profit and loss sharing is also equal to the contribution made. Contribution is therefore, cornerstone in the formation of a company. Contribution can be made either in cash or in kind.

The other term is "Common stock" and "common purpose". According to this definition the contribution made by the shareholders is no more the property of the shareholders. It is consolidated to one common ownership of the company and it is the company not the shareholders who owns those properties contributed to the company. The relationship between the contribution made and the contributor is in the term of shares. The shareholder owns the shares in proportion of his contribution not the property he contributes. If he wants to go out of the company he may get the value of his share not the property he contributed.

"Common purpose" is another important phrase we find in the definition. A company is formed to achieve common business purpose of the share holders. The company is mainly established to fulfill these common objectives. It can not do outside of this common purpose. If it does, it would be ultra vires i.e. it is beyond its powers and, therefore, void.⁵ The common purpose of the company defines and limits the purpose of the company.

Now, we will turn to the definition provided under commercial code of Ethiopia.

What is defined under commercial code of Ethiopia is "Business organization" not company. Accordingly, Art 210 and 211 provide the following

210(1) A business organization is any association arising out of a partnership agreement

(2) Any business organization other than a joint venture shall be deemed to be legal person

211- A partnership agreement is a contract whereby two or more persons who intend to join together and to corporate undertake to bring together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out thereof, if any.

The first element that appears in this definition is that business organization is formed by "partnership agreement". This partnership according to the definition given above is a contract. Contract according to civil code"... is an agreement whereby two or more persons create ... an obligation..." The Commercial Code similarly states that members entered into contract to form business organization.

It is clear that any company or partnership is based on an agreement of contractual nature and the intention to participate in profits and losses. However, such contractual nature may not sufficient for a company though it may hold true for partnership.

Nowadays, the company has lost its contractual nature. The rules that govern company are mandatory nature and can not be contracted out.⁶ consequently company is more often an institution than a contract. For example, when business organization is share company and private limited company, resolution is passed by majority vote. Minority share holders can not decline to perform majority decision by raising that they did not contract among each other or they may not raise the defense that there was no meeting of minds among all share holders to the decision passed.

"Partnership agreement may be more applicable to partnership rather than company because it is personal element that dominates in partnership. Personal qualities of partner such as his intelligence, capacity, and behaviors required in partnership⁷ and if such quality of partners is missed the partnership may be canceled.⁸ On the other hand, company is an institution. It has its own constituent document.⁹ In most cases it is a question of accepting the document or not to accepting. Amending or varying the document needs its own procedure. The withdrawal of any shareholder does not bring changes in the document. So, the commercial code gives its definition, across the board without recognizing these disparities.

The second element included in the partnership agreement is "common purpose". It is true that business organization is established to carry on the common purpose of the shareholders. On the other hand when common purpose is not achieved this can be one of the grounds for the dissolution of the business organization.¹⁰

Common purpose according to this definition is of economic nature. Economic nature in this sense is an activity for gain as enshrined in Art 5 of commercial code. It is an activity concerned with the object of earning profit for the benefit of the members. Such economic nature of activity is the profit motto or income oriented activity.

There is an intention among members that the profit gained should be shared at least in part among its members.¹¹ The members must also contribute to the loss incurred by the members.¹² This is the indispensable counter part of the right to share in profit.

The third element is plurality of persons. There are two or more persons to form business organization. However a one-man company is excluded. Of course, a one-man-company is a recent development which cannot be imagined during the promulgation of

commercial code of Ethiopia. The French company law which has an influence to the commercial code of Ethiopia adopted a one man company by the law of 11 July, 1985.¹³ So, we don't expect a one-man-company in 1960. But, the current draft Commercial Code, drafted by Ministry of Justice and which is under discussion in its Art 510(2) has designed of adopting a one-man company. It states that "not with standing the provision of one-man private limited enterprise [one-man-company] members of the company shall not be less than two and more than 50" However, the draft commercial code has provided no where about a one-man-company in its all text though it says "not with standing the provision of one man-company" even it is not clear as to the adoption and its formation.

The fourth element is contribution. Business organization can only exists if each of the participants makes a contribution to its assets in consideration for which he receives one or more shares in it. Contribution may be in cash or in kind.¹⁴

The fifth element is legal personality. Under commercial code of Ethiopia, as well as French company law, both partnership and company is legal entity.¹⁵ Under Common Law System, partnerships are not legal entity. It is only company that has legal

personality. This is the main distinction between common law and civil law systems.

B. Salient features

1. Legal personality under commercial code of Ethiopia

Winship, in his supplementary materials for business organization, said that, professor Escara, who is drafter of commercial code, was instructed to prepare draft commercial code along continental line. So, the commercial code of Ethiopia was prepared according to the continental legal system.¹⁶

Common law and continental European law followed two different approaches regarding legal entity of partnership and company.

In ancient times, the needs of commerce resulted in the recognition of the usages of merchants and traders as law, often, by courts composed of the merchants themselves. Over the centuries developed a body of law known as the "law of merchant"¹⁷ ("Lex mercantia"). Gradually, this law influenced local law and contributed for uniformity and stability of commercial transaction. Substantive law like laws of agency, partnership, and corporations were part of development of law of merchant.¹⁸ This body of law

was administered by separate courts. It survived intact and this body of law was developed into commercial law in continental Europe, i.e. civil law.

Civil law with its national codification of 19th and 20th centuries has as a result of influence of law merchant adopted corporation or company and various forms of partnership as a separate legal entity. Because under law merchant both corporation and partnerships were having legal personality and they are distinct from the members forming them.¹⁹

On the other hand, common law system, specially in England, the administration of the law merchant was originally administered by separate courts but gradually taken over on a case to case basis by the common law court and the law merchant's legal entity was preserved for corporation.²⁰

Therefore, we observe that the theory of legal entity, in civil law system applies both to company and partnership while the theory of legal entity in common law system is applied only to company not to partnership.

Thus, commercial code of Ethiopia being inspired by civil law system adopted legal personality for both partnership and company.

Art 210 (2) of the general provision of law of business organization states that any business organization except joint venture is legal person. However, when we come to the effect of legal personality, there may be some inconsistencies. One of the effects of legal personality is distinctiveness. The entity is distinct from the persons forming the entity. This is true for share companz²¹ and private limited company.²² But it is different when we come to partnership.

Partners of the general partnership are personally and jointly responsible to creditors of the partnership.²³ On the other hand, general partnership is legal entity. Legal entity stands by itself independent of the members forming it. But under commercial law of Ethiopia which is also true under French company law, partnership as an entity does not have its own liabilities. In company form of business organization shareholders carry on business in oneness as a single natural person under legal personality of the company while partners under general partnership are traders,²⁴ the partnership itself is also a trading partnership.

The other effect of legal personality is perpetuity and succession. Legal entity once formed is not dissolved with death,

bankruptcy or change of any individual forming the entity. Perpetuity and succession is one of the main features of legal entity. But when we take an example of general partnership, despite, the fact that it is legal person, events such as death, incapacity and bankruptcy of the members cause the partnership to be dissolved.

2. Limited Liability

a) Theoretical Analysis

Limited liability, which is a fundamental consequence of separate legal personality, is the principle as a result of which the members of an insolvent company do not have to contribute their own money to the assets of the company in the liquidation to meet the debt of the company.²⁵ However this general rule holds true if members have paid fully their share contribution. Conversely, if members have not fully paid their share holdings, they are responsible to the extent of the unpaid amount. To put in another way, members of the company cease to insure liability to contribute to the debts of the company once that shares held by that member have been fully paid. A company with a limited liability is therefore, responsible for its own actions and will be liable for its own debts.

The principal advantage of legal personality of a business organization is undoubtedly the limited liability of a company's membership. The fact that the company is limited liability, encourages many people to invest their money in the company, because, people are entitled to engage in commercial activities without necessarily involving the whole of their fortune in that particular business.²⁷

Further more, limited liability is proposed because it encourages the channeling of resource in productive business enabling the investor who has capital to invest it in the company without having to worry much about the liabilities being incurred by the company.

However, limited liability is not without limitation. It creates recklessness. Share holders know that liability beyond their holding will not affect them. They expect distribution of dividends and if there is no dividend, they clearly know that there will be no liability to their personal property. This condition creates recklessness among the share holders.

In addition, the business is carried on by few management group, and the share holders will not be able to control or manage such company directly. There is very loose sense of ownership and

motivation of business is very loose. In such case not only does the company bears the loss but the innocent creditors have to bear the loss as well.

Companies may be classified as companies limited by shares and companies limited by guarantee. Briefly, I will discuss both of them in light of limited liability.

i) Company limited by shares

Such companies must have share capital. Share capital in this context is the capital raised by a company by the issue of shares.¹⁵ Share capital may be raised either at the time of formation of the company for starting business operations or latter on for further expansion or diversification of the business. But once raised share capital becomes a permanent liability of the company and not paid except at the time of winding up.²⁸

In company limited by shares, the liability of the share holders is limited to the amount unpaid only. Such is indicated in the memorandum of association of the company. Such liability can be enforced either during the existence of the company or during the winding up.²⁹ Company limited by shares is public or private companies.

Public company limited by share is a company which has number of members unlimited, a company in which public can subscribed for its shares and shares are freely transferred.³⁰ This company may also offer its securities to the general public (ibid).

On the other hand, a private limited company is a company with small concern business. Mostly, share holders in this company are participating in management. The relationship between the shareholders of a small private company is one which is usually built up on mutual trust, and confidence. They control the company's destiny. It can not offer its security to the general public.³¹

ii) Company limited by guarantee.

It is a company either public or private in which the liability of the members is limited to contribute to the assets of the company in the event of wind up.³² In this company members are obliged to pay their respective contribution or extent of liability at the time of winding up while in company limited by shares, members are forced to pay their share contribution when the company is operational or at winding up. Further more, in company limited by share, members contribute initial capital while in company limited by guarantee such initial capital can be gained

from donation, fees, charges, or some other incomes. Company limited by share is purely trading company while company limited by guarantee can be club, trade association, research association and societies for promoting various objectives.³³

This company has both memorandum and articles of association. The liability that each member has to pay should expressly be stated in the memorandum. In other words members should give guarantee that when the company is wound-up, they will contribute the amount of shares, held by the company capital, if the asset of the company is not sufficient to pay its debts. Though the amount guaranteed can not be called-up. So, such guarantee seems "reserve capital"

b) Limited liability under commercial code of Ethiopia.

Under commercial code of Ethiopia, we have two types of companies. They are Share Company and private limited company. Whether these companies can be divided into companies limited by shares or guarantees is not clear. It is also not clear whether these companies are private or public. We will examine the provisions of commercial code, and reach at some conclusions.

i) Share Company

Title VI of the commercial code states the heading as "companies limited by shares." but the Amharic version names the title as "Share Company". Further more, the newly draft commercial code name the title as "share business enterprise". All of them are different. For a time being this author like to focus on the English version, of commercial code which he think is appropriate, though the Amharic version prevails.

Share company as the heading itself states is a company limited by share. Art 304 of the commercial code states the following.

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

Previously, we have seen that companies limited by shares have share capital. The above Art states that, Share Company has share capital divided into shares. In company limited by shares initial capital is raised by the members and the rest will be raised either during the currency of the company or at the winding up and the raised amount becomes an asset of the company.

In Share Company of commercial code of Ethiopia, one-fourth of the subscribed capital is paid up³⁴ and be deposited in the bank in the name of the company under formation and the rest may be paid within five-years after formation.³⁵ when contribution is made in kind shares are fully paid at the time of formation.³⁶ The amount paid is also part of the asset of the company. Therefore, as it is stated at the heading, Share Company under commercial code of Ethiopia is company limited by share and we don't have Share Company limited by guarantee.

Then we will see whether this share company is public or private. A company is public when a public can subscribe for its share, shares are freely transferable, and members can be more than 50.

Share Company under commercial code of Ethiopia subscribes shares to the public.³⁷ As a principle shares of this company are freely transferred. The minimum members of the company is five and the ceiling is unlimited.³⁹ with these justifications we can say that share company is public company. But this company is also private company. Members of the share company may not subscribe shares for the public.⁴⁰ In this case members distribute shares among themselves and may close

distribution of shares for the public, such act is permitted under Art 316 of the commercial code. Members may also restrict the free transfer of the shares of the company⁴¹ which is the character of private company that we have seen previously. These two characters are main features of the private company and because of these share company is private company.

Thus, Share Company is both public and private company. When the English version of the code says "Companies limited by share" the word "companies" is used to denote public and private share company. Therefore the Ethiopian share company as stated under commercial code is a public or private company limited by share. The extent of liability is also to the amount of unpaid shares. If members pay their share holdings fully, liability is met by the asset of the company, but if they don't pay fully, their liability is to the extent of unpaid amount.

ii) Private limited Company

Title VII of the commercial code of Ethiopia states "private limited company". There is no indication, whether this company is limited by share or guarantee. It is clear that this company is private. The name itself states that it is a private company. On top of this, the code limits members of this company minimum to two

and maximum to fifty.⁴² This Company can not issue transferable securities⁴³ and shares are not freely transferred. So, it is a private company according to our previous discussion.

The next issue is whether this company is limited by shares or guarantee? Previously, we have seen that a company that is limited by share has share capital, and share capital is a capital raised by the issuance of shares. We have also said that in company limited by share, share holders contribute the initial capital of the company. In this company there is no an express provision as to the contribution of the initial capital. But Art 517 (g) states that "a statement that the capital is fully paid." The code says "a statement" but not proof of payment". A statement is simple declaration without presentation and evidence for the payment of the capital. Under share company, Art312 (1) (b) states that, one-fourth of the subscribed capital must be paid up and be deposited in the bank by the name of the share company under formation. But, in private limited company it is simply declaration that the capital is fully paid. Even when the contribution is made in kind members are expected to agree on the method of valuation of the contribution whether such contribution is really contributed or not is not clear. In Share Company contribution made in kind is

contributed upon formation before registration.⁴⁴ So, private limited company is not a company limited by share.

Next, we will see whether this company is limited by guarantee. We have already seen that in company limited by guarantee, members are obliged to contribute, the share contribution, when the asset of the company is insufficient to cover its liability during wind up. But we don't find such expression in the provisions of private limited company. We have also seen that company limited by guarantee is not always trading company. Nevertheless, private limited company of commercial code of Ethiopia is always deemed to be of commercial nature.⁴⁵ Accordingly, private limited company is limited liability Company neither by guarantee nor by share.

3) Constitution of the company under commercial code of Ethiopia

We noticed that ancient Ethiopia was known for her foreign trade. Adulis was amongst the developed commercial center in Red sea. But as to how the ancient Ethiopians were forming their business were not known. However, it might be true to say that business at this sate was carried on individualistically.

The other development in commercial transaction is the coming into existence of company law in 1933. From this time onwards company was formed according to the law of company. Memorandum and articles of association were the essential documents to form company. Now we will see both documents.

a) Memorandum of Association

It is noted that legal personality is required for all business organization in civil law system while such legal personality is required only for companies in common law system. Memorandum of association is one of the prerequisites for legal personality. So, it is clear that this document is requirement for business organization in civil law system as well as under commercial code of Ethiopia.

Memorandum of association is prerequisite for Ethiopian general partnership,⁵¹ limited partnership,⁵² share company⁵³ and private limited company.⁵⁴ But it is not prerequisite for joint venture³⁵ since it is not legal person.

According to Art 213 of commercial code of Ethiopia ordinary partnership has dual characters. Where it is formed to carry on commercial activities it is deemed to be general partnership, and general partnership needs memorandum of association for its

formation. Therefore, it is true to say that all commercial partnership and companies need memorandum of association for their formations.

In general, memorandum of association under commercial code of Ethiopia contains name of business organization, registered office clause, objective clause, liability clause and capital clause, which have similarity with the medieval age deed of settlement. The company cannot depart from the provisions contained in the memorandum. If it does, it would be ultra vires and therefore void. "The memorandum is as it were, the area beyond which the action of the company can not go, inside that area the shareholders may make fit".⁵⁵

According to Garage, memorandum has two objectives. The first one is that the shareholders who invest money in the company shall know within what field it is to be put at risk. They can find out from the memorandum the field or the purpose for which their money is going to be used by the investment. The second is that any person who deals with the company shall know without reasonable doubt whether the contractual relation into which he intends to enter with the company is one relating to the matter within its object. Thus, money or goods supplier of the company

will know whether the transaction he intends to make with the company is within the objects of the company and not ultra vires of its objects.⁵⁶

As a whole, memorandum is an essential document that enables the shareholders, creditors and all others who deal with the company to know what company's powers are and what the range of its activities.

b) Articles of association

Articles of association are rules and regulations enacted by members of the company. Commercial code of Ethiopia gives power to ministry of trade and industry to prepare model of articles.⁵⁷ And members can adopt this model with necessary modification. Since Articles are rules that govern internal relationship, the freedom to enact is given to the share holders. In case of memorandum the code states what it should contain and unless the indicated particulars are included in the memorandum, the registrars will not register the company.

The articles play a part subsidiary to the memorandum of association. they accept the memorandum of association as a charter of incorporation of the company and so accepting it, the articles proceed to define the duties, the rights and the powers of the governing body as between themselves and the company at large and the mode and the form in which changes in

the internal regulations of the company may from time to time made.⁵⁸

So, articles are subordinate or supplementary to memorandum of association. Though the articles are supplementary to the memorandum, yet if there be any ambiguity, in the memorandum, the articles may be used to explain it.

The articles have a contractual force between company and its members as also between the members inter se in relation to their rights.

Under commercial code of Ethiopia, it is only share company⁵⁹ and private limited company⁶⁰ that needs articles for registration. But as articles are internal regulations, if need be partnership can prepare such regulations, as there is no prohibition of drafting articles for partnership. On the other hand partnership is not obliged to have articles as it is true for both companies. So, articles are optional for partnership while it is obligatory for companies under commercial code of Ethiopia.

Notes

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¹⁰ ibid, Art 215(1)

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³³ Com. C. Art 338 (1)

³⁴ ibid, Art 338(2)

³⁵ ibid Art. 339(1)

³⁶ ibid, Art 317

³⁷ ibid, Art 333

³⁸ ibid, Art. 317(!)

³⁹ ibid, Art 316

⁴⁰ ibid, Art 333

⁴¹ *ibid* Art 510(2)

⁴² *ibid*, Art 510(3)

⁴³ *ibid*, Art 319(1)

⁴⁴ *ibid*, Art 10(2)

⁴⁵ Abera Jembere, Legal History of Ethiopia 1934-74: Some Aspects of substantial and procedural laws (Rotterdam, Erasmus university Leiden African 1988) p. 103

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⁴⁷ *ibid*

⁴⁸ Vincent Powellsmith, The Law and Practice Relating to Company Directors: (London, _____, 1969) p. 53

⁴⁹ Abera Jembere, Legal History of Ethiopia 1934-74: Some Aspects of substantial ----- Procedural laws (Rotterdam, Erasmus University Leiden African, 1988) p. 108

⁵⁰ Com. C. Art 284

⁵¹ *ibid* Art, 298

⁵² *ibid* Art 313

⁵³ *ibid* Art 517

⁵⁴ K. C. Garage, Company and Secretarial Practice 2nd ed. (Ludiano, Kalyani Publisher, 2002) p. 97

II. Board of Directors under Commercial Code of Ethiopia

A. Board of directors defined.

No definition has been provided, for board of directors under commercial code of Ethiopia. However, Art. 358 of the code states that "No decision may be taken by the board of directors unless a majority of directors is present, from this Art. One can understand that board of directors are group of persons who exercises decision making of company management or we can say that board of directors are a body consists of directors which manages the company.

To Manage:

---- is that function of an enterprise which concerns itself with direction and control of the various activities to attain business objectives. Management [to manage] is essentially an executive function; it deals with the active direction of the human effort.¹

So, board of directors under commercial code of Ethiopia is established to act or manage the company on behalf of the shareholders. Board of directors, frame the general policy of the company, direct, and control its affairs. According to Hahalo:

"Board of directors means any body who controls or governs corporate body . . . or group of persons which controls or governs corporate body

or where there is no such body (or group, who is a member of that corporate body".²

Both Hahalo and Samy give emphasis that board of directors is body that manage, directs and controls the business activities of the company. So, board of directors is a body consist of commercial men that manages a trading concern for the benefit of shareholder.³

In French company law, as well as commercial code of Ethiopia, it is only Share Company that is managed by board of directors. In both legislations, private limited company is managed by one or more managers under the direction and control of the shareholders.⁴ There fore, board of directors are only applied to share company under commercial law of Ethiopia.

However, there are two opinions as to the management of the private limited company. The first opinion is that private limited company can be managed by board of directors. The proponents of this idea say that since the code does not prohibit management by board of directors, management by board of directors is possible.

The second opinion is that private limited company should be managed by one or two managers because the code under art 525(1) states that "a private limited company shall be managed by one or more managers." This is obligatory provision which does not give loophole for directors to manage the company.

As to the opinion of the writer, it is the second opinion that sounds. The provision that states private limited company shall be managed by one or more managers is obligatory. There is no way to derogate this provision. So, in the absence of any permissive provision, it is difficult to make law under the disguise of the interpretation of the law.

B. Qualification of directors

Board of directors is established by directors who are elected by shareholders. This directors must have some qualifications.

There are two opinions as to the qualifications of directors:-

1. The first opinion is no qualification is required for a person to be a director other than holding of what ever number of shares. There

is no academic requirement or any other test of fitness or character.

2. The second opinion is that the appointment of directors should meet certain requirement. The composition of the board of directors should conquest different professionals. A person having entrepreneurial skill is best candidate for board of directors.⁵

The first requirement is traditional qualification adopted by much legislation. The second approach is new development which introduces a professional qualification for directors UK institute of directors has said that, it needs to introduce a professional qualification for directors.⁶ In which case "chartered directors" can be created. According to the institute there will be an examination and normally three years board experience before obtaining the title. Candidates will also need a proposer and two secondres and will undergo a one-hour interview.⁷ This is the beginning in UK otherwise in most legislation there is no professional qualification. Most legislations even do not prescribe a minimum and maximum age of the directors. However, some companies have introduced a retirement age for directors, usually from 65-70 years⁸ some companies have established the post of "directors emeritus" or "honorary director" who may attend meetings, participate in discussion, and enjoy all of the rights and privileges of a directors except voting (ibid). In effect they are invitee's consultants.

Some times it might be happened that a director can be a director for more than one company. In normal situation, it may not be problematic, but if the companies which have one director in common are rivalry, there might be conflict of interest between the companies. In such case the companies should be given the opportunity to disqualify the director. Of course, not only in such specific cases but also in general where there is conflict of interest, first of all such person should not be permitted to hold office of directorate, and secondly, even if he holds the office, he must be disqualified.

Furthermore, the new trend with respect of directors is competency and commitment for a company business. The fate of the company is in the hands of these few groups of persons. If they carry on company business competitively, they make their company and shareholders wealthy, if not the company will go bankrupt. Nevertheless, share qualification does not mean that it is worthless. It is believed that share qualification creates sense of ownership among the directors and it is assumed that they feel motivated to work for the success of the company. However, it is practical experience that it is these directors who tried to be benefited at the expense of the company.

When we turn to commercial code of Ethiopia we observe that it adopted the first opinion.⁹ A person to be a director must be share holder,⁵ then he has to deposit as security some fixed number of shares. The code states that the amount of shares to be deposited is fixed in the memorandum of association.

Note, has to be taken that such share qualification should not be expressed in memorandum, because in the preceding chapter we have seen that memorandum of association governs the relationship between the company and third party. The share qualification is between the company and the share holders. It is an internal relation. Such internal relation is governed by articles of association. So, the code should have stated that such share qualification is provided in the articles of association.

The code further states that the share deposited shall not be given back to the directors as much as they stay in the office. However, no memorandum has ever seen prescribing such qualification shares.

Moreover, we observe some qualifications apart from share qualification, under a proclamation for licensing and supervision of insurance business. Under art 33 of this proclamation, a person can not be appointed as a director of a company, if

a) he is adjudicated bankrupt as

i) Sole trader

ii) Partner

iii) Manager of the company or

b) he has been convicted of offence under penal code of Ethiopia other than petty offence.

Some company laws state what has been provided by this proclamation. They even add some other disqualification. For instance, Indian Company Law disqualifies the following persons from directorate.

When a person, is unsound mind, un discharged insolvent, has been convicted an offence involving moral turpitude, has not paid any call in respect of shares of the company held by him, has been disqualified by an order of the court.

The commercial code of Ethiopia as well as the draft commercial code states membership and share qualification as the only qualification for the directorate.

It is writer's opinion that the draft code could have adopted the new development of the qualification of the board of directors. Since, the business of the company is in the hand of directors; such directors should be qualified in business management. They

should foresight the prospectus of the company and could lead the business affairs.

C. Appointment of directors

The successes of a company depend to a great extent, upon the competence and honesty of its directors. It is, therefore, desirable that the administration of companies should be in right hands.

A director under commercial code of Ethiopia is appointed by statutes of the share company, general meeting and by the directors themselves.¹¹

Directors may be named by the statutes i.e., memorandum or articles of associations. Promoters or founders of the company prepare statutes for the formation of the company. They also name the directors in the statutes which is known as "first directors". The founders present these directors to first meeting of the subscribers for conformation. General meeting of subscribers may endorse the appointment or may reject. If it rejects it appoints new directors.

First directors, as much as, they are named in the statutes, are statutory directors. Their removal needs amendments of the statutes, because the named directors are part and parcel of the

statutes. Amendment of the statutes requires special arrangement of extra ordinary meeting. This makes removal of directors inflexible. As the result of this, such directors will be untouched and stand by themselves disregarding shareholders who elected them. The writer thinks that is why the code under Art 313 (which states the content of Share Company's memorandum) does not made names of directors to be indicated. Instead, the code makes number of directors and their powers to be specified in the memorandum. But in practice, the directors as well as the managers are named in the memorandum of association. At the result it becomes difficult to remove the directors and mangers when ever need arises.

The numbers of appointee directors are not less than three or more than twelve (com. cod. Art 347(2)). The general meeting of the subscribers decides the number of directors. Where the number of directors is fixed, and this number fails below the fixed number the directors can not function because they are empowered or delegated to exercise the company management with this fixed number. Such number may be fixed based on the size of the shareholders and nature of the company.

Further more, appointment of subsequent directors is made by general meeting of the shareholders. The election is made by rotation, that means all directors are not replaced by new directors but some number of directors are elected and respective number will be retired. This helps experienced directors to remain in the office. The remaining directors will share their experience to the newly elected directors.

The commercial code states that not more than two directors are simultaneously replaced. But it is difficult to exercise practically when it is compared to the number of directors and term of office. Suppose the numbers of directors are twelve, in order to elect rotationally it needs six years. But one director may not be appointed for more than three years.¹² So, it is better to elect 1/3 of the appointed directors, as it is true, under Indian Company Law.¹³ Retiring directors are also eligible for appointment to the office of directors.¹⁴

In addition, the code states, that when the directors "leave" the board, the remaining directors may appoint directors to fill the vacancy.¹⁵

It means as if the directors voluntarily resign but there are other reasons why directors may vacate their office. Such vacancy

may occur by reason of death, bankruptcy, in case of insurance company incapacity and sickness. The appointed directors should hold office only up to the date of the next annual general meeting.¹⁶ The general meeting may conform to the appointment of the directors or elect other directors, but all acts done by the directors appointed by remaining directors is valid, even though if his election is not conformed.¹⁷ The code does not provide for how long the directors so appointed may be in their office, It is logical to say that the directors appointed by remaining directors will hold office till the end of the term of the director in whose place he is appointed.

Finally, the code states that if the remaining directors are less than half of the number of the directors, they can not fill the vacancy by appointing the directors, instead they shall call general meeting to elect directors.¹⁸ If there is no remaining director's auditors shall call the meeting to elect the directors.¹⁹

D. Board's meeting as a necessity of Exercising Power.

Traditionally, the authority to manage the affairs of the company is vested in the directors not individually, but as a board. As a general rule they can act to bind the company only when they act as a board in the meeting.²⁰ Commercial code of Ethiopia is

enacted in the above stated manner. Accordingly, "No decision may be taken by the board of directors unless a majority of directors is present. Decisions shall be taken by an absolute majority..."²¹

It is general rule under commercial code of Ethiopia that the power to exercise decision making is vested in the meeting of directors consisting of majority. This is the power given to the directors as a board. The shareholders have an interest in the manner in which the authority is exercised, i.e. it should be exercised in meeting in which majority is present. In addition, the decision has to be taken by absolute majority. It seems the demand of the law is that the directors shall meet and counsel with each other, and any determination affecting the company shall only be arrived at after a consultation at meeting of the board attended by at least the majority of the directors. The share holders are entitled to the advantage coming from their combined wisdom, knowledge and business activities. The minority board members should also be heard, even though the majority decision is eventually the one that controls.²²

At the result of decisions taken by meeting there are two benefits first, company is protected from unauthorized directors' act against share holders and secondly, the protection of third

parties with whom the directors have dealt with transgressing the limits of their authority.

Directors are the representatives of the share holders, and while performing their duties, they are governed by the principles governing agent- principal relationship. So, the authority conferred by the share holders up on directors. This is assumed that this will form part of contract between the shareholders and it is a condition attached to their delegation of the power of management to the board.²³

Decisions taken without fulfilling these conditions are therefore, invalid, or it is a decision taken outside of authority. On the other hand, in agency law, the principal may ratify the act when the agent performs his duty outside his authority. With the same token, if, a transaction is carried in the name of the company by directors, without fulfilling the procedure, it may be ratified by the shareholders meeting. In such case the decision is binding on the company, but if the shareholders do not ratify, the liability lies upon directors who failed to follow the procedure.²⁴

Furthermore, the commercial code states that in order to conduct legal meeting, majority of the directors must be present in the meeting. If, for example, there are nine directors in the

company, the minimum number that constitutes majority is five. if the present directors are less than the majority, meeting can not take place and even if conducted, the decision taken may not be binding the company. Therefore, when majority, is not obtained all what can be done is to adjourn the meeting.

The code also states that decisions are taken by absolute majority of the directors present in the meeting. We have seen in above example that in the company having nine directors, the majority that can hold legal meeting can not be less than five. In order to pass legal decision, the vote of three directors is required. Accordingly, directors who make decision may be less than the majority of the board.²⁵

Most legislations do not permit directors to be represented by proxy. They demand directors to be personally present in the board meeting. However, among rare legislations which permit proxy of directors is the law of Louisiana. According to this law, directors are represented by another director or share holder at the meeting of the board.

Commercial code of Ethiopia is also among those rare legislations that permits proxy of directors by another director. A director according to the code is only represented by another

director. Shareholders can not represent directors at the board meeting.

However, there are some exceptions to the traditional rule that company can not act without board meeting. One situation is when the business of company is very small or when the company itself is close-hold Company. In such condition the separate consent of all directors will be sufficient to bind the company without any formal meeting as a board or even in some cases the consent of majority, though acting separately.²⁶

There is no such exceptional condition for Share Company under commercial code of Ethiopia. But there is such exception for private limited company.²⁷ In private limited company, as a principle decisions are taken by meetings of shareholders. Nevertheless, there are conditions in which the manager of the private limited company sends text of resolution to each shareholder and asks for the shareholders to give their vote in writing.

The other exception is where the shareholders empower the executive officer of the company with the powers of directors as a usual method of doing business, in which case the board of directors is inactive or, may have the advisory role to the executive director, otherwise all other major decision is taken by the executive offices, without the need of board meeting. Ratification by the shareholders meeting, mentioned above is also an exception to the general rule of directors to exercise their power only through meeting of the board.

Notes

- ¹Rama Samy, Principles of Management 2nd ed.,
(Mubani, Himaleya Publishing Press House, 1999)
p.3
- ² Levy A. B, Private Corporations and their Control, (
Brad way House, Route edge and Konganpoul Ltd
1950) p. 50
- ³ Stevens, Private Corporations 2nd ed., (Paul Minn,
West Publishing Co. 1999). p. 225
- ⁴ Com. C. Art 525 (1)
- ⁵ Vincent Powell Smith, The Law and Practice Relating
to Company directors (London, _____, 1699) p.14
- ⁶ Smith and Keenean's Company Law for Students,
(11thed England, Clays Ltd, 1999) p. 275
- ⁷ibid, p. 141
- ⁸ Harry C. Henn, Laws of Corporation, 3rd ed (New York,
West Group, 1983) p. 553
- ⁹ Com. C. art 347 ff
- ¹⁰ ibid, Art 349
- ¹¹ ibid, Art 350
- ¹² Ibid, Art 350(1)

- ¹³ K. C. Garage, Company and Secretarial Practice 2nd ed. (Ludhiano, Kaly an publisher 2002), p. 382
- ¹⁴ Com. C., Art 350(4)
- ¹⁵ *ibid*, Art 351(
- ¹⁶ *ibid*, Art 351(2)
- ¹⁷ *ibid*
- ¹⁸ *ibid*
- ¹⁹ *ibid*
- ²⁰ Henrry Ballantine, Ballantine on Corporations (Chicago, Callaghan and company, 1946) p. 123
- ²¹ Com. C. Art 358(1) :
- ²² Stevens, Private Corporation 2nd ed., (Paul Minn, West Publishing Co., 1949) p. 658
- ²³ *ibid*
- ²⁴ com. C. Art 366
- ²⁵ Stevens Private Corporation, 2nd ed, (Paul Minn, West Publishing Co., 1949) p. 25
- ²⁶ Henry Ballantine, Ballantine on Corporations (Chicago, Callaghan and Company, 1946) p. 129
- ²⁷ Com. C. Art 533

III. Powers of Board of Directors

The company management is composed of two main organs. They are the general meeting of shareholders and board of directors. Share Company under commercial code of Ethiopia holds different kinds of meetings.¹ Meetings of share holders enable them to exercise their right as proprietors. Share holders in the annual general meeting discuss the affairs of the company, pass the accounts, appoint directors etc. In extra ordinary meeting they consider a particular matter of urgent, the consideration of which can not be postponed to next annual general meeting.² The amendment of the constitution of the company is also made by this extra ordinary meeting.³ Special meeting is held by shareholders of particular class,⁴ to transact their interest only.⁵

Therefore, general meeting of the shareholders has ultimate managerial function. The board of directors which formed by general meeting of shareholders has a delegate power in matters of regular business management. In addition, there is general manager who acts day to day activities of company.⁶ Now, we will see the powers of directors in relation to the general meeting of the share holder and general manager or managing director. Finally, we

will examine one pending case in light of powers of board of directors.

A. Division of Powers of Board of Directors and General Meeting.

It is traditionally accepted that the board of directors is the supreme and original authority in business management. Directors are the chief administrators to whom as a board the power of managing the ordinary business of the company is delegated. On the other hand, the power of board of directors is delegated, and so restricted to the management of the regular business affairs of the company. Its power, for example, can not extend to the fundamental changes in the character or organization of the company or to wind-up of the company.

There are two approaches of conferring powers the board of directors and general meeting of shareholders. They are the "Liberal and Restrictive" approaches.⁷ The restrictive approach is to confer the power the board of directors and general meeting by specifying in the memorandum or articles of association. According to this approach board of directors has limited power. Ballantine summarized such power in the following points.

1. The selection of the chief executive and senior officers and seeing that able young executives are being developed.



2. Control of executive compensation, pension and retirement policies
3. Delegation to the chief executive and his subordinate executive of authority for administrative action.
4. Fixing policies as to pricing, labor relation expansion and new products.
5. Determining dividend, payments, financing and capital changes
6. Supervision and vigilance for the welfare of the whole enterprise.⁸

This approach is adopted by the continental European legal system or civil law system.

French company law, which is one of the models of continental European legal system, and which is also the model of commercial law of Ethiopia, confers the powers specifically to the board of directors. Accordingly, the powers of board of directors are the following.

1. Drawing up an annual inventory of the corporation's assets and preparing the annual accounts.
2. Calling share holder meetings
3. Authorizing all agreements entered into directly or indirectly between the corporation and its directors or executive officers.
4. Filing the vacancies on the board of directors
5. Appointing and dismissing the chairman of the board and the executive officers and determining their remuneration
6. Moving the registered office within the same district or to the adjacent one
7. Allocating of the remuneration of the board among the directors

8. Authorizing the chairman to give guarantees
on behalf of the corporation⁹

The second approach which is mostly followed by USA legal system is to confer specific power to general meeting such as the power of altering constitution of the company, appointment and removal of the directors, and conferring all other powers to the board of directors.¹⁰

In such case it is unnecessary to specify any particular powers to the board of directors. In other words, except powers specifically given to the general meeting, all other powers are vested in the board of directors. Thus, in this view board of directors of a company has the power to borrow money when it is needed in the business of the company, to mortgage the property of the company to assign all the property of the company unless such powers are expressly reserved to the general meeting. In restrictive approach such power of mortgage, assignment of business or real estate is exclusive power given to the general meetings.

Under commercial code of Ethiopia powers shall be given to the board of directors by the law, memorandum, articles of association and resolution passed by the meetings of shareholders.

Furthermore, these sources can be categorized into two. The first source of power to board of director is share holder. Powers

that emanate from memorandum, articles of association and general meeting of shareholders are powers that are given to board of directors by shareholders.

The second source is commercial law of Ethiopia. In this law powers are given fragmentally here and there. When we look into the code we find the following powers of board of directors:-

- Keep records of management, accounts and books, convening meetings of general meetings, setting up reserve funds and applying to the courts when the company stops payments¹¹
- Preparing agenda for the meeting¹²

This indicates that commercial code of Ethiopia adopted the restrictive approach of empowering the board of directors.

Further more, in the first chapter of this paper we have seen that the drafter of the commercial code of Ethiopia was instructed to prepare the draft of commercial code in line with European continental legal system. This system follows the restrictive approach of empowering of board of directors. However, except in few provisions here and there, there is no power restrictively given in commercial code. Restrictive power like French company law could have been given. Had such powers ~~have~~ been given; it would

have been serviced as guidance for shareholders to give additional powers to board of directors.

With this remarks, we can conclude, that the commercial code of Ethiopia adopted the restrictive approach of empowering the board of directors. Therefore, powers of board of directors are specifically given in the law, the memorandum, articles of association and resolution of general meeting.

B. Powers of Executive in Relation to the Board of Directors

We have already seen that the management of a company is fully vested in the board of directors. We have discussed in preceding chapter, that board of directors exercises its powers in the meetings. The power is given to the board as a body not to individual directors. Thus, it is difficult to manage day-to-day activities of the company through daily meetings of the board. The board then manages day to day activities by delegating its power to the executive officer, known as general manager or managing director. There are some differences between these concepts. We will see each of them and their, applications under commercial code of Ethiopia.

1. General Manager

As a general rule, day to day activities are carried on by general manger, under commercial code of Ethiopia. The general manager is appointed by the board.¹³ it is also general rule that general manager is not member of the board of directors.¹⁴ This is to avoid potential conflict of interest and to ensure that the appointment of directors may always be freely revoked by the board of directors.¹⁵ General Manager is an individual who under the direction of the board of directors has the management of the affairs of the company in whole or substantially.¹⁶ General Manager is accountable to the board of directors.

2. Managing Director

Managing director is:-

A director who by virtue of an agreement with the company or of a resolution passed by the company in general meting or by its board of directors, or by virtue of its memorandum or articles of association, is entrusted with substantial powers of management which would not other wise be exercisable by him...¹⁷

This definition makes clear that managing director is appointed from members of board of directors. It means that a person who is not a director can not be appointed as a managing director.

Suppose a person who appointed a managing director vacates his office of director, it follows then that his appointment of managing director terminates automatically.

The other indication of this definition is that managing director is appointed with the agreement of the company or resolution passed by the company in general meeting or resolution passed by its board or the memorandum or articles of association.

The first option which states managing directors are appointed with the agreement of the company indicates as if there is some other body may have an agreement or interest with company to appoint managing directors. Such can be third party or creditors who may wish the managing director to manage or minority shareholders.¹⁸

The phrase which says managing director is entrusted with "substantial power" also indicates as to some power but different from an ordinary power of general manager. According to Garage, the power of managing director should not be the power to do administrative acts of routine nature such as affixing the common seal of the company to any document, drawing and endorsing a cheque on the account of the company signing and certificate of share, but substantial power consists of laying down policies and

company.¹⁹ The above discussion is the experience
system especially of UK and India. Next we will see
Ethiopian experience.

In legal system, there are two structures of
the first one is board of directors. It is a traditional
element of the company. Theoretically it is assumed
directors participate in management but practically,
the chairman is controlling the company. It is the chairman who
manages the company. The chairman of the board of director
has general management of the company with some
exceptions. For example, he alone can not give a
resolution. For example, he alone can not give a
resolution without the express authorization of the board; he has to
act within the limits of the company purpose. His
powers can be restricted by memorandum or articles of
association or resolution passed by board of directors.²⁰

The second structure is to use supervisory and executive
boards. The supervisory board controls the executive board. The

company law also does not make any distinction between the "substantial" and "ordinary" power. In case of "managing director" we have said that he only exercise substantial power. But in French company law all executive officers are equally exercising the management function. i.e. substantial and ordinary power.²¹

In commercial code of Ethiopia we find neither the French management structure nor the common law, i.e. "managing director". But day to day managerial activity is carried on by general manger. The general manager may not be director and he is an employee of the company.²² However, a close examination of Art 362(2) may lead to different result which is exception to the principle above stated. it states that articles of association of a company may specify that directors or one director may be responsible as a manager.

This indicates that one director or more directors can be responsible as a manager. The code further states that they are exercising their power in the name of company²³ from these provisions we can conclude that manager can be appointed from among the board of directors provided it is stated in articles of association. But, such "managing director" is not the same as that we have seen in common law system. In common law system we

have seen that managing director is entrusted with "substantial powers" in which case there will be additional manager, who exercises ordinary managerial activities. On the other hand, in French company law and commercial code of Ethiopia, a manager who is appointed among the directors or executive is entrusted in both substantial and ordinary managerial functions. In both legal systems where there is "managing director" or executive officer there is no additional manager who exercises ordinary business activity.

Thus we can say that:-

- a "managing director" is possible under commercial code of Ethiopia, which is an exception to the general rule which says directors may not be managers"
- The number of managing director may be one or more among the members of the board.
- the appointment of "managing directors" should be specified in the articles of association

a) Appointment of managing director

Under commercial code of Ethiopia it is stated that directors can act as manager but no further details or even clues have been given as to the appointment of managing directors. From foreign legislation we learn that managing directors are appointed either by the board of directors or general meeting of share holders. The commercial code of Ethiopia simply states that 'director' can be specified as a 'managing director'. As to how and who will appoint has not been given. The writer thinks this is an option left for the decision of the meeting of the shareholders. Therefore, shareholders, may decide that 'managing directors' are appointed by the board of directors or meeting of share holder.

b) Removal of 'managing director'

We have said that the appointment of "managing director" can be authorized by articles of association to the board of director or meeting of shareholders.

When the articles give power of appointment of 'managing director' either to the general meeting of shareholders or board of directors, it is also true that removal of managing director is also vested in the same organ. Note has to be taken that when director acts as a managing director he is an employee of the company. He

has dual character as a director and as an employee of the company, so, removal of director from his position of managing directorate may not be removed of from the position of directorate. But when he is removed from directorate, he may be removed from the position of managing director.

C) Case analysis, regarding powers of Board of Directors

File No. 6797

Federal First Instance

Court Old Airport

Addis Ababa

Plaintiffs:- share holders of Idget Behibret Yegebeya Adarash share company, (eight shareholders)

Defendants: Board of directors of Idget Behibret yegebeya Addarash (twelve directors)

Summary of the statement of claim

1. The company was formed by petty -traders of werada 23 of Addis Ababa city Administration.
2. The company applied to Addis Ababa city Administration lease office for a plot of land
3. The office issued the company with a plot of land based on lease agreement. The land was leased by the company only to founding members. The number of founding members was 1114
4. Board of directors began to admit new members, by selling the plot of land, and the number of members was raised to 1556.

5. Directors issued identification card to members from time to time. Directors did not renew previously, issued identification card. Instead, they used to issue new one. This was done deliberately, because, they intended to exclude some share holders, who criticize them. Share holders who do not hold identification card cannot participate in general meeting of share holders. Plaintiffs are among those who deprived these rights.

6. On the other hand, share holders were forced to contribute money under the guise of "strengthening the company". The following contributions were made from time to time.

- To fence the plot of land obtained by lease, Birr 518,000
- to Publicize shareholders name Birr 115, 400
- Payment for land lease Birrr, 1,780,825
- Share capital Birr, 129, 500

Total 2, 583, 725

7. In addition in all previous meetings, audit report was not submitted or heard.

8. Therefore, the plaintiff alleged the following:

That:-

- a) They should be registered as founding members
- b) The additional share holders be cancelled
- c) The accounts be audited
- d) Existing board of directors be removed
- e) Board of directors be liable jointly and severally to the plaintiff.

Comments

1. Admission of new members

In chapter one of this thesis we have seen that the classification of companies are private and public companies. Share Company under commercial code of Ethiopia is either private or public company. If a company is a public company an offer of subscription is made to the public by the founding members through prospectus.²⁴ It means an invitation is issued to the public inviting the public to deposit money with company to take shares of the company. According to the fact stated above defendant directors, did not invite the public for subscription. Nevertheless, even if they have invited the public it would be outside the scope of the company law and their power. Because, the company is a private company. The above facts state that the plot of land was leased only for 1114. Numbers of members was fixed. The allocation of the land was given to be shared among founding members. Thus, members and third parties know that the company was private company. But directors of the company raised the number of the members without the knowledge of the member and outside of their delegated power. Directors shall pursue and exercise what is delegated to them in the law, memorandum and articles of

association, however, great the necessity may be, if they do, it would be ultra vires the company and, therefore, wholly void. Hence, their act should be void, and directors should respect the interest of their principal, shareholders.

2. Issuance of Identification card

Defendant directors used to issue identification card for the shareholders, while they ought to issue share certificate. On the other hand, commercial code of Ethiopia nowhere provides the issuance of share certificate. No stipulation has been cited as share certificate. What all the code states is about shares. The code states that every company must have register of shareholders at its head office and any interested person may obtain the extracts of the register within one month.²⁵ However, commercial Register and licensing, council of minister regulations No. 13/97 states that "a specimen of share certificates for each class of shares" is requirement for share company to be registered.²⁶

Share is an interest in the company measured in terms of money²⁷ shareholder's loss and profit is to that extent. It is an incorporeal movable property consisting rights and duties.

Defendant directors used to issue identification card for shareholders of the share. Identification card indicates that the holder of it is a member of that organization. Identification card of Addis Ababa University, for example, indicates that the holder is either employee or student of Addis Ababa University. But share certificate is a document issued by the company which indicates that the holder is owner or entitled to the specified number of shares of a certain class and that they are fully paid or paid up to the stated number²⁸ Share certificate expresses membership. It also expresses the proprietary relationship between the company and the share holder. But identification card does not express proprietary relationship.

A share certificate is issued under the seal of the company. It is a prima facie evidence of the title of the member to such share ²⁹ while identification card is not an evidence of title. Thus, if a company issues a share certificate to a person it can not afterward allege that that person is not entitled to those shares.

The defendants therefore,

- Should have registered all share holders in the register books and

- Should have issued share certificate to the share holders.

Finally, defendant directors had performed an act outside of their power, which was ultra vires the company.

3. Money Contributions

Initially, members of the company have contributed share capital. Birr, 129, 500 this was a capital of the company. The liability of this company is also this specified amount of capital. Liabilities of shareholders were also to the respective shares related to this capital.

Furthermore, a company may raise its capital to meet its objective. If this capital is not sufficient, it may increase its capital by issuing new shares³⁰ An increase of capital is done when a company desires to expand its activities or it is in need of more capital.³¹ It is clear that the defendant company was in need of money to fence its plot of land, for payment of lease, etc. To meet these objectives, the contributions demanded by the company were not accounted to their shareholdings, as well as, to the capital of the company. The capital of the company remained at its initial stage i.e. Birr 129, 500. But a member has already contributed more than Birr 2, 000, 000.

Hence directors of the company exercised their power outside of the law and constitution of the company. They abused their powers by excluding member according their wishes and interests.

4. Audit Report

Share Company carries its business by capital furnished by the share holders. The owners of the company are dispersed. So, they are weak to control the affairs of the company. Commercial code of Ethiopia, therefore, provides an appointment of an auditor to examine the affairs of the company and report them to shareholders. The examinations by independent agency, i.e. auditors are practically the only safeguard which the shareholders have against the company or their money being misappropriated without their knowing any thing about it.

To escape from such examination, defendant directors avoided the assessment of their functions. They put themselves in the position of absolutism, whose performance is un criticized and un assailable. It is traditional of the company that audit report is one of the agendas to be submitted to the annual general meeting of the shareholders. However, defendant directors missed these important functions of the general meeting of the company for their selfish interest. Their act is contrary to the law, memorandum and articles of association and therefore void and null.

Notes

¹Comm. C. art 390

² K.C. Garage, Company and Secretarial Practice 2nd ed.,
(Ludhiano, Kalyani publisher, 2002)

³ Comm. C. Art 423

⁴ibid, Art 335-336

⁵ibid, Art 426

⁶ ibid, Art 348(3)

⁷Vincent Powell Smith, The Law and practice Relating to
Company Directors, (London, _____, 1969) p. 103

⁸Henry Ballantine, Ballantine On Corporations. (Chicago,
Callaghan and Company, 1946) p. 146

⁹ Jean Pierr Le gall, French Company Law 2nd ed (London,
Long Man Groopp, 1992) p. 107

¹⁰ Henery Ballantine, Ballantine on corporations (Chicago,
Callaghan and Company, 1946) p. 148

¹¹Comm. C. Art 397

¹² ibid, Art 362

¹³ ibid, Art 348(1)

¹⁴ ibid. Art 348(4)



- ¹⁵ Jean Pier Le gall, French Company Law 2nd ed., (London, Longman Groop, 1992) p. 101
- ¹⁶ K. C. Garage, Company and Secretarial Practice 2nd ed., (Ludhiano, Kalyani Publisher 2002) p. 446
- ¹⁷ ibid, p128
- ¹⁸ K.C Garage, Company and Secretarial Practice 2nd ed. (Ludhirano, Kalyani Publisher, 2002)
- ¹⁹ K. C. Garage, Company and Secretarial Practice 2nd ed. (Ludhirano, Kalyani Publisher, 2002) p. 429
- ²⁰ Jean pier Le gall, French Company Law, 2nd ed., (London, Longman group, 1992) p.113
- ²¹ Ibid, p. 114
- ²² Comm. C. Art 348(4)
- ²³ Comm. C. Art 363(3)
- ²⁴ Ibid, Art 338(1)
- ²⁵ ibid Art 331 (1,4)
- ²⁶ Commercial Register and Business Hencing A.A. 6(3)
Regulation, 1997, Leg. No. 13 No. 28 Neg. Gaz. Year 3
- ²⁷ K. C. Garage, Company and secretarial Practice 2nd ed. (Ludhirano, Kalyari Publisher, 2002) P 236

²⁸ William E. Knepper, Liability of Corporate Officers and Directors, (Indian Police, the Allen smith Co, 1969) p. 197

²⁹ibid, p. 264

³⁰Comm. C. Art 464(2)

³¹ K.C. Garage, Company and Secretarial Practice 2nd ed., (Ludhirano, Kalyari Publisher, 2002) p. 205

IV Liabilities of Directors

Under commercial code of Ethiopia board of directors is considered as an institution. But, when the Liability is considered directors are responsible either individually or jointly.¹ So, if an individual director or directors are dissent from a faulty decision of the board of directors and such is minted and be sent to the auditor, such director or directors are not responsible for the decision taken.²

The term liability denotes legal responsibility to another and is of two types. They are civil and criminal liabilities.³ Criminal liability is committed by commission or omission⁴ while civil liabilities are committed when one causes damage upon another's property or moral. There are two types of civil liabilities; they are liability that emanates from contract and liability that emanates from non contractual liability. Contractual liability is applicable upon contracting parties while non-contractual liability is applied upon all persons.⁵

Accordingly, we will discuss liabilities of directors in light of civil and criminal liabilities.

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⁵⁵ ibid

⁵⁶ Com. C. art 314(2)

⁵⁷ K. C. Garage, Company and Secretarial practice
2nd ed. (Ludiano, Kalyari Publisher, 2002) p. 123

⁵⁸ Com. C. Art 314

⁵⁹ ibid, Art 518

A. Civil Liabilities

Board of directors, while exercising their powers, may render themselves liable in civil matters. Directors may enter into contract on behalf of the company. They may breach some duties and bring damage on the company. Directors also may contract with third party on behalf of the company. They are not liable when they are doing within the scope of their powers, but if they exceed their powers, they may be liable to the third party like ordinary agent is liable to the third party.⁶

Next, we will deal with liabilities of directors to the company and third party.

1. Liabilities to the Company

Directors are appointed by general meeting of shareholders. They are appointed to exercise the management functions for the company. While exercising these functions, they may owe to the company certain duties. Breaching of these duties may make directors liable to the company. Liability of directors may occur as a result of negligence, breach of trust and ultra virus.⁷

a) Negligence:- It is a failure to exercise the standard of care that a reasonable prudent person would have exercised in a similar

situation. The standard of care imposed upon the company directors is with "due care".⁸ It is the degree of care which reasonably a prudent person would exercise in the conduct of his own affairs of like.

In preceding chapter we have analyzed the case in which eight share holders were plaintiffs and twelve directors were defendants. The objective of that company was to build market center with in a short period of time. But, since directors were engaged in their private benefits with the expense of the company, they did not construct the market center in the time provided. The company, therefore, might have claimed loss severed or benefit, it would have enjoyed, had the construction been done in due time.⁹

However, as we have seen, the case was brought to the court by eight shareholders who were banned from membership. In order to institute proceeding against directors resolution to remove directors has to pass. The law is lenient regarding such resolution. At least one fifth of vote of the capital is required and the same meeting can remove the concerned directors.¹⁰ It is assumed that directors manipulate the direction of the case not to be instituted against them. We have seen that any one who criticized them was losing their membership. What ever the case may be, director

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should have been made liable for their gross negligent by the company not by plaintiff shareholders, who instituted the case to redress for themselves not the company.

b) Breach of trust:- As directors are trustees of the company, they must exercise their powers in good faith in the interest of the company. They can not use the trust property for their own personal interest.

Under commercial code of Ethiopia we do not find any statutory provisions dealing with breach of trust. To understand the concept of trust, we have to refer to civil code of Ethiopia. Civil code that deals with trust is part of bailment. Bailment according to civil code is "a contract where by one person, the bailed undertakes to receive chattel from another the bailer, and keep it on the latter's behalf"¹¹ Here the company is bailer and directors are bailees. The property bailed is always the property of the bailer.¹² When we say directors are bailer [trustee] of the company it does not mean the general principle of bailment or trust that it is in its technical meaning.

The civil code states that only movable properties are bailed, but in case of directors Vs, company, the whole property of the

company movables or immovable are bailed to the directors. So, as bailer can not use¹³ the bailed property for his own sake, so, the directors can not use the property of the company for personal purpose. If the bailer uses the bailed chattel, he has to pay the use made to the bailor¹⁴, the same has to apply to directors used the company property for their personal benefit.

In one court case,¹⁵ plaintiff shareholders pleaded that their company was engaged in building of business shops. In first phase 18 shops were built up. Directors, 12 in number, have distributed these shops among themselves and also shared for the rest six share holders whom they favored. Plaintiff alleged the distribution to be cancelled and deed of title of the shops to be injected. The court has injected the transfer of deed of title. Further, it is difficult to imagine what, will be the court decision since the case is pending. However, it is clear that directors, of this company were appointed to manage the company in the interest of the share holders. They shall not be benefited at the expense of the property of the company and the company has the right to get back all the benefits acquired by the directors. It is the duty of directors to administer the company property for the common benefits. They are agents of the company who are entrusted with the management

of the company business solely in the interest of the company.¹⁶ Directors are bound to perform their duty as bailee would have performed. If they breach such bailment, they are responsible for civil liability i.e. is to pay back all benefits they gained as the result of breaching trust. As we will see latter on the right of the company to get back the benefits may be enforced in an action by the company or shareholders actions.¹⁷

Further more, such breach of trust may arise in various ways. Since directors have secret information of share price, they may purchase shares in lower price and may sell in higher price for the company or directors may purchase a share in lower price and may sell at high price to the outsider or directors may have chances to obtain for themselves business opportunities which are offered to or are available to their company, or may divert the company business opportunity for their personal gains. In all these case such directors have to account the personally gained benefits, for the company. Such activities are strictly prohibited in our law¹⁸.

C. Ultra Vires: We have already stated that under commercial law of Ethiopia the source of powers of directors is the law, memorandum, articles of association and resolution of general

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meeting of shareholders. In preceding chapter of case analysis we have seen that the company was private company. The number of member of the company was fixed to the founding members. But directors violated the power given to them in the company document for their selfish interest. They admitted additional shareholders. Directors have done acts which are in excess of their powers, or which are ultra vires and directors are personally liable to the company for any loss.¹⁹

Directors are also liable to the company when they make payments of dividends from the capital of the company. Art 458 (1) of commercial code of Ethiopia states that "dividends may only be paid to shareholders from the net profit shown in the approved balance sheet". According to this provision dividends are only paid when there is profit. Directors are not empowered to pay dividends from the capital of the company or they are not entrusted to pay dividends when there is no net profit. In such case they are liable to the company because they violated the law of the country.

Then, it follows that, if directors pay dividends in the absence of profit, they have to pay back the amount paid with interest.

Moreover, if directors invest company money outside of the company purpose, they shall be personally liable. But if the

ment is profitable, do directors be liable? do the profit go to directors the answer is yes directors are liable because they company funds for the object outside of the coampny. This is fires. They are liable for the contravention of the objective of company. On the other hand, the fund invested belongs to the ny and profit is also outcome of the coampny funds, ore, the profit has to come to its owner, i.e. the company not directors. Directors may be liable because they violated the iver of the company. There is no loss of the fund and they may e liable regarding the loss. Had the loss occurred, they would been liable both for infringement of the objective of the any and the loss occurred.

Liability to Third party (creditors)

We have repeatedly, said that directors are agents of the any. Agency may therefore, be regarded as particular form of privity, namely to create or affect relations between principal (i.e. any) and third part.²⁰ So, in this context, agency is a onship in which principal (company) instructs the agent to r into commitment by the name and on behalf of the principal.

Commercial code of Ethiopia gives emphasis to preserve the asset of the company intact and makes directors liable to third party when they fail to preserve intact the asset of the company.²¹ Directors are liable to the third party to the extent of the assets of the company.²² Third party, especially creditor, demands their debt from the capital of the company, when it is wind up.

They can not demand their debt more than the capital of the company. So, in order, the company capable to discharge its debt, directors have to preserve this capital intact.

Directors, for example, do not have the power to pay dividends from the capital of the company, in the absence of profit.²³ The task of declaring profit is the task of directors. But they are empowered to declare these dividends only from net profit. The code strictly states that dividends shall be paid from net profit and approved balance sheet. The directors who might have paid a dividend from capital of the company is, therefore, liable to third party.²⁴

B. Criminal Liability

In addition, to civil liability, directors are also criminally liable, when their intentional act result in committing offence. They

are personally liable, because the penal code of Ethiopia states that, "the offender who is responsible for his act is alone liable to punishment under the provisions of criminal law"²⁵

We shall take two instances in which directors may be criminally liable.

1. False statement- directors may issue false statement in different ways. One way may be statement of information in prospectus. This document constitutes the basis of the contract between the company and the person who purchase shares. A prospect, therefore, must tell the truth. It must also not conceal any fact which ought to be disclosed.

In penal law of Ethiopia, there are provisions defining specific offences which relates to the company activities and in many instances such provisions are made applicable to all persons, whether in notice to the public or in proposal or reports taking, commercial firm founder members, managers, directors, member of board of directors. So, if directors give a false or willful exaggerated statement intended to deceive any person as to the real value of any shares, such directors may be punished with simple imprisonment and fine pursuant to the penal code Art mentioned above.

2. Breach of Trust- We have already said that directors, though, are not technically trustee of the company their relationship to the company is like that of trustee. They must not only protect the interests of the company but must also refrain from doing any thing that injury to the company. The directors:-

Owes loyalty and allegiance to the corporations a loyalty that is undivided and allegiance that is influenced in action by no consideration other than the welfare of the corporation... he [the director] may not conflict with its rights... In the discharge of his duties a director must, of course, act honestly and in good faith.²⁶

If directors breach this trust they are criminally liable under penal code of Ethiopia.²⁷ One who breaches trust is punishable with simple imprisonment or rigorous imprisonment not exceeding five years and in the case of aggravated breach of trust the punishment shall be simple imprisonment not less than three months and rigorous imprisonment not exceeding ten years.

C. Actions against Directors

When directors are liable actions should be taken against them as directors are liable to the company, share holders and

third party actions are also taken upon them by the company, shareholders and third party.

1. Actions by the Company

Company as an independent legal entity is represented by the board of directors. The board of directors alone represents the company for legal relation with third party and shareholders. But when directors mismanaged the affairs of the company, resolution is passed by the meeting of shareholders to remove him or them from the position of directorate and proceeding is instituted upon the concerned directors.²⁸ either by the remaining directors or by newly appointed directors. The commercial code of Ethiopia gives primary duty to the company to take action against directors guilty of management". Share holders can not override the directors' representative powers. As we shall see later on share holders can not intervene in the management of the board of directors. In general, the management and control of the company are entrusted to the directors to the advantage of the shareholders, and since instituting proceeding upon directors who mismanaged the company is part of management of the company, it is the directors, who institute the proceeding on behalf of the company.



2. Actions by shareholders

In general, the acts of management are vested in the board of directors. Instituting of proceeding as a part of acts of managements is also instituted by the board of directors. But there is time when share holder intervenes to take action against the directors. Commercial code of Ethiopia states that such intervention is only permitted, when resolution is passed by general meeting to institute proceeding against directors, by the remaining or replaced directors and, if these directors failed to bring the action on concerned directors within three months after the resolution is passed²⁹ The code, therefore, gives priority power of bringing action on directors by the remaining or newly appointed directors. It is only if they are not voluntary to bring actions against directors that share holders can institute proceedings.

The code is silent as to the conditions in which shareholders intervenes. Knepper says that if the following conditions are occurred in the company management, shareholders intervention is absolutely necessary. The conditions are the following.

1. That the corporation is not being adequately represented
2. That the stock holders [shareholders] personal rights are being damaged or impaired,

3. Where an unfair settlement is proposed
4. Where a conclusive dismissal of the action has been procured and under similar circumstances.³⁰

These conditions can also be applied under commercial code of Ethiopia. But before the shareholders commence, to bring a derivative suit, shareholders are required to pass resolution by general meeting to the effect that, the proceeding has to be taken against the directors, who are in default.³¹

The purpose of such resolution is required to give a company or directors to rectify an alleged wrong without litigation. This requirement is important because the shareholders derivative action is an exception to the normal rule that proper party to bring a suit on behalf of a company is the company itself, acting through its directors "to say it in other way, before the shareholders are permitted to take control of the management of the company's law suit from the board, the shareholders must establish either that he or she has requested the board to take action and the board has wrongfully failed to do so, or that the board is not in a position to manage the litigation.

The proceeding is instituted by representative of shareholders in derivative³² action. It is "an invention of equity to supply the

want of an adequate remedy at law to redress breaches of fiduciary by corporate managers"³³

In most cases directors who do not fulfill their duties attempt to suppress any wrong acts by using their power. In preceding chapter we have seen that directors who mismanaged the management of the company used to expel shareholders who criticized them. That shareholder, thus, did not use, derivative right to protect the right of the shareholders in which representative of shareholders may sue in the shareholders rights. But they brought the case only to the benefit of themselves, which they would have made for the rest shareholders.

The action which is brought by derivative action is not of the plaintiff but is of the shareholders. It is an act which takes place when directors unable to protect the representative. The shareholders are a real party in interest, and it is a necessary to the action represented by shareholders, which would have been represented by directors.

It has to be noted that unless the company has cause of action there is no recovery in a shareholder's derivative act. Any defense that would be good for the company, if it had brought the action is likewise good against a claim asserted in its behalf in shareholder's derivative act. And the remedy granted to the

company or its representative must be the same as if the directors had filed the suit.

3. Actions by Creditors

Directors are held liable to the company's creditors where they fail to keep the company capital intact, and eventually, the asset of the company is unable to cover the debt. Such action is based on the principle that directors are not only trustees of the company but also trustee of the creditors.

We have already seen that commercial code of Ethiopia strictly prohibits payment of dividends when there is no profit.¹⁵ If directors pay dividends in the absence of profit, they are liable to creditors. The base of actions is breach of trust, negligence or contravene of commercial code provisions and they are criminally and civilly liable.³⁴

The liability imposed on creditors can be instituted either by joinder of creditors or representative of creditors.¹⁶ Such liability exists for the benefit of all creditors and must be enforced in an equitable proceeding for the benefit of all of them unless the liability goes only to single creditors.

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Notes

¹Comm. C. Art 364(2)

²ibid, Art 364(6)

³ Nigatu Tesfaye, Non-Contractual Liability and un Lawful Enrichment (Amharic Version Addis Ababa, __2003) P. 8

⁴ Penal C. Art. 23

⁵Nigatu Tesfaye, Non-Contractual Liability and Un Lawful Enrichment (Amharic Version) (AA. __) p. 8

⁶Civil C. Art 2144

⁷K. C. Garage, Company and Secretarial Practice 2nd ed., (Ludhiano, Kalyari Publisher, 2003) p. 407

⁸Comm. C. Art 364(1)

⁹ ibid, art 364(1-4)

¹⁰ ibid. Art 365 (3)

¹¹ Civ. C. Art 2779

¹² ibid Art 2783(1)

¹⁵Amanuel Tsegashar co. Share holders V. Amanuel
Tsega Share co, Board directors (Paulo's first instance, CT.
Computer no, 084492014) unpublished

¹⁶William E. Knepper, Liability of Corporate Officers and
Directors (Indian Police, the Allen Smith Company, 1969) p. 7

¹⁷ Comm. C. Art 365

¹⁸Comm. C. Art 357

¹⁹ ibid C. Art 364

²⁰ Roy Goode, Commercial Law 2nd ed (England, Clays
Ltd, 1995) p. 168

²¹Comm. C. Art 366(1)

²²ibid Art 304(1)

²³ibid Art 458(1)

²⁴ ibid Art 458(1) Cum 366(2)

²⁵ibid Art 48(1)

²⁶ Haryy C. Henn, Laws of Corporation 3rd ed (New York, West Group, 1983) p. 626

²⁷LPenal C. Art 640

²⁸ Comm. C. Art 365

²⁹Comm. C. Art 994 ff and 1159

³⁰ William E. Knepper, Liability of Corporate Officers and Directors. (Indiana Police, the Allen Smith Company,)p. 140

31 Comm. C. Art 365

32 ibid

33 H. R. Hahalo Company Law through the Cases 2nd ed
(Cape Town, Juta and Company Limited, 1996) p. 91

³⁴ Comm. C. Art 458 (2)

V. Duties of Board of Directors

Duties are in light of individual directors note duties of board of directors as an institution. This is true to liabilities of directors discussed in previous chapter.

Duties of directors are acts that directors are obliged to perform in law and moral. In most case duties of directors are interrelated to powers and liabilities of directors. In this chapter we will examine duties of directors under commercial code of Ethiopia. We will also analysis one pending case regarding duties of directors.

The duties of directors are said to be three fold. They are obedience, diligence and loyalty.¹ As to obedience directors must owe a duty to keep within the power of the company and board of directors with regard of diligence, the directors owe a duty to exercise reasonable care and prudence and loyalty to act truly and faithfully.²

These general duties of directors can be split further into detailed classification. They are

- A. fiduciary duty
- B. Duty of care and skill
- C. Duty to attend board meetings

D. Statutory duties.³

Now, we will examine these duties in light of commercial code provisions.

A. Fiduciary duty

We have already seen that directors are supreme organ in the management of the company. We have also discussed that since directors are agents of the company, they must exercise their powers in good faith and for the benefit of the company and shareholders. This is fiduciary duties of directors.⁴ Fiduciary duty is not only related to good faith, but also it requires fair dealings with a company.

Under commercial code of Ethiopia, these fiduciary duties are provided from Art 355-357. We can summarize the whole provisions into two. They are:-

1. Competing with the company and
2. inside trading

1. Competing with the company

We have repeatedly said that there is principal agent relationship between company and directors. As agent acts with

strictest good faith towards principal.⁵ So, do directors towards the company. The commercial code of Ethiopia strictly prohibit that directors may not enter into any activity in which there is a possibility that the director personal interest could conflict with those of the company, which directors bound to protect. The code strictly states that directors are not allowed to be partner with joint or several liabilities with competing companies or against the company by himself or on behalf of any third parties.⁶ In the preceding chapter we have seen that directors are trustee of the company and should protect the interest of the company as a bonus pater familias.⁷ If, they failed to perform their duty, they are responsible for their act.

However, the code provides exception to this general rule. Where the private competing business of the director is authorized by the general meeting of the company, such act will be legitimized. The competing director may have a valid claim against the company, or the company may cease to have a competing business and in such case the general meeting may authorize the act as a legitimate act.

2. Inside Trading

Directors know the inside and outside situation of the company. Especially they have an access to inside information of the company which have not been public. Consequently, they make secret profit by using this information. According to the fiduciary relation they may not directly or indirectly derive any personal profit or advantage by reason of their position that is not enjoyed in common by all share holders.⁸

In respect of inside dealings, the code states that, such dealings must be approved by the board of directors and notice be given to the auditors.⁹ The auditors also present such dealing for the general meeting of the share holders.¹⁰ The meeting may approve or reject the dealings.¹¹ If the meeting approved the dealings, the dealing becomes effective. But if the dealing is not approved the director concerned is liable to the extent he gained the profit. If the concerned director fails to meet the liability, the code makes the remaining director to make good the damage.¹²

On the other hand, practice tells us that directors involved in such activities are very strong. They don't refrain from lobbying remaining directors, auditors and shareholders to get approved the dealings. Such directors can easily make the remaining director to cooperate to their ideas.

A position of auditors may be a little bit difficult. In principle it is true that auditors are safeguards of the shareholders. They are

appointed by general meeting of shareholders and they are accountable to the same body.

However, the "truth" lies in different position when we come to practical application. Initially, it is a board of directors who presents the nomination of auditors to general meeting. In most cases the meeting approves the nomination. At the same time it is board of directors who presents the removal of auditors to the general meeting and the general meeting conforms what is presented. So, it is board of directors who plays a decisive role for the appointment and removal of auditors. Therefore, auditors may be biased, and approve the dealings approved by the remaining directors and may positively present such dealing to the general meeting. In addition, the concerned directors also try to get support from individual shareholders by lobbying and manipulation. Thus, it will be very difficult to cancel internal dealings of directors. The code does not state whether the approval is required before or after the dealing is executed. From the reading of the provision it seems that approval is required after the execution of the dealings because it is general meeting that approves and general meeting is mostly conducted annually. So, it is after the concerned director benefited from the dealings that the act is retroactively approved, which makes the position of the concerned director stronger financially.

Now we will examine one pending case related to fiduciary relations.

Federal High Court

Addis Ababa

File No. 21703

Plaintiff Agri-Make Ethiopia Share Company

Address- Addis Ababa, Kirkos K/Ketema kebele 10 house
No. 987/26

Defendant: Ato Lioulseged Bekele

Address- Addis Ababa NifasSilk Lafto k/Ketema Kebele
55 House No. 408

Facts of statement of claim

- Plaintiff was engaged in cotton plantation in Gambela regional state
- Defendant was director as well as general manager of the plaintiff company
- During his service time, defendant has done the following acts
 - He established rival business enterprise named "Lulu business enterprise".
 - This business enterprise operates similar business activity with the plaintiff company
 - To run his business activity, defendant used plaintiff's office, telephone, staff etc

- Eventually he earned birr 271, 363, 90 personal profit at the expense of the company business.
- Further more, defendant advertised an auction for sale of cotton. Defendant short listed a person engaged in similar business activity and presented for approval for the meeting of the board of directors. The board approved the proposal. The board also decided the price of one quintal of cotton to be sold at birr 650. But, defendant at the result of special relation he had with purchaser and having the knowledge of the market price, sold one quintal of cotton for birr 875.00 earning personal profit of Birr 210,000.
- In another business transaction which was dealt with Awasa Textile Factory he sold 1800 quintal of cotton for birr 1, 483, 000. He said that he had paid VAT,² birr 222, 450, which, of course, he attempted to make his personal profit under the disguise of VAT. But the company negotiated with purchaser and reduced the said VAT to Birr 53, 205.61.
- Defendant borrowed money from his spouse at the interest rate of birr 3% per month. He paid interest Birr 875 which he ought have to pay birr 525 according to the legal interest.

- Finally, defendant borrowed birr 100,000 from a company called Agro -Techno-Service. In Agro-Techno-Service Ato Tilahun is head of department who is entitled to sign cheques. At the same time, Ato Tilahun is a director of the plaintiff company, who signs cheques in the plaintiff company. Ato Tilahun permitted the loan and signed. The cheque issued by lending company was post dated. When the cheque was presented for payment it was found that there was no fund. Finally Birr 35, 000 was not paid to the plaintiff company.

Plaintiff alleged

1. To account all profits gained as the result of competing enterprise and internal information
2. Legal interest upon all profits
3. All other expenses such as court and attorney fees.

Case Analysis

The case of defendant director can be divided into two categories.

They are

1. Rival Business
2. Inside Trading

1. Rival Business

Directors are given wide scope in management of the company affairs so long as they exercise an honest, unbiased judgment in a reasonable manner. But if they exercise their power against the common interest of the shareholders or company they are responsible for their act.

The defendant director diverted the power given to him for his private benefits. He formed his own business enterprise which has similar business activities with the company he managed. At the same time he used the facilities of the company for his newly established enterprise. He was executive director for both business enterprises. Since the business is of the same kind he pulled all business opportunities towards his own enterprise.

Previously, we have said that directors are trustees of the company. So, as trustee can not use the trustee property for his personal gain, directors can not use company business for their personal gains, too. It is directors' duty to administer company business for the common benefit of the shareholders. But, the defendant directors turned all company businesses and facilities for his personal gain. He breached the trustee relationship. Art 355 of commercial code of Ethiopia states that general meeting of

shareholders may authorize or ratify such act. But the act has not been authorized. Therefore, the defendant is liable. His liability is not limited to civil liability, as stated by the plaintiff but also extends to criminal liability (further, see preceding chapter)

2. Inside Trading

Defendant advertised to sell the cotton on auction. He made the meeting of the board to decide the price below market price but he sold the cotton in market price. By doing so he diverted the company profit opportunity for his own personal gain of Birr 210,000, which would have accounted to the company.

Defendant director had borrowed money from his wife at the interest of 3% per month. Dealing with his wife would be with the director himself¹³ or it is possible to say that the director was participant in or beneficiary of his wife's transaction. He borrowed at the rate more than legal interest.¹⁴

Defendant also borrowed birr 100,000 by colluding with the director of the lending company. In both loan agreements, the defendant director gained his personal profit by using internal information. He breached his trustee relation and he is liable both criminally and civilly, though the plaintiff alleged only civil liability.

B. Duty of Care and skill

Commercial code of Ethiopia states that directors have to exercise their powers with care as though the agents do.¹⁵ Accordingly, directors have to do with that amount of care which an ordinary man would be expected to take, if the business of the company was his own.¹⁵ (garage 2002, 404).

On the other hand, directors are not bound to give continuous attention to the affairs of the company. It is of intermittent nature. They are obliged to attend periodical board meetings.

Therefore, in duty of care and skill

... a director need not exhibit in the performance of his duty any greater degree of skill than could be expected from a reasonable diligent person, the diligent person being imputed with the general knowledge, skill and experience that may reasonably be expected of the holders of the position in question.¹⁶

Thus, a director need not exhibit in the performance of his duty a greater skill than may be expected from person of his knowledge and experience. In respect of all duties that having regarded to the need of business may properly be left to some other official.

However, while exercising his duty of care and skill, he must not permit his self interest to influence the interest of the company. As we have seen in earlier court case he must not exceed the

boundaries of the authority conferred upon him. In principle the defendant director was expected to exercise care and skill and to devote to the company business the amount of time and attention expected from him by the share holder or company, which are his principal.

Directors, therefore, should owe a duty of care and skill while discharging their responsibility. When we say "care" it means "a duty of attention".¹⁷ Accordingly, directors are obliged, before acting, to inform them of all materials information available. Having become so informed, they then must act with requisite care in the discharge of their duties. Then they will be held liable for breach of the duty of care if they act negligently (discussed in previous chapter).

However, mere errors of judgment or acts of imprudence will not necessarily constitute a breach of duty. What is important is that in order to comply with the duty of care, a director must pay diligent attention to the business affairs of the company in which he holds office.¹⁸ If a director's non performance of an act, which is his duty to perform may result in breach of his duty of care he is responsible for his act.

C. Duty to Attend Board Meeting

In chapter two of this paper we said that directors exercise their power of management functions only when they meet in board meetings. Management power is vested in the board rather than in directors individually. Therefore directors have to attend board meeting except for a rare exceptional conditions. On the other hand, when such exceptional condition happened, the absentee director can be represented by proxy.¹⁹ A proxy, according to the commercial code of Ethiopia is the other director.²⁰ But in foreign legislations there is no restriction of proxy, only upon the remaining directors.²¹ Proxy can be even from shareholders. However, when proxy is outside of the remaining directors, the management of the board may be strange to such outsider and may take time to accustom to it. In this case the commercial code option may be preferable.

In preceding sub chapter of this chapter we have said that directors are not obliged to give continuous efforts to the affairs of the company but to the periodical meetings. Board meeting is not a day to day activity. It is periodical for specific period of time. So, directors have to attend the meeting unless they are in force majeure.

Further more, directors should give a reasonable care to attend the board meetings. In other words, they have to give a reasonable amount of attention to the affairs of the company. In as much as possible and when ever they are able to do so, they have to attend the meeting, but, in exceptional case they are not bound to attend all the board meetings.

The attendance becomes very important because directors are elected to act on behalf of the shareholders. The powers were delegated to them to act as the shareholders would have done of themselves.

D. Statutory Duties

In addition to the duties dealt within an earlier part of this chapter there are some duties of directors stated as statutory duties. The earlier discussion of duties of directors is duty emanated from the agency principal relationship or some powers emanated from commercial code impliedly. The present duties are directly stated by commercial code under Art 362.

Directors are duty bound by statutory duty to keep records of management and meetings. Directors have to keep accounts and books. Submission of the accounts to the auditors and annual report to the general meeting of the company is also an essential

duty that is always to be considered. Controlling of directors is mainly possible through the auditors' report and annual report of the directors to general meeting.

These statutory provisions are clearly given in the code provisions. Despite it is clearly provided in the code directors are seen mismanaging these duties in different ways. In chapter three of this paper we have analyzed, the case. In that case directors were not convened general meeting regularly. They did not submit annual report properly upon the meetings which was conducted rarely. There was no auditors' report.

Conducting annual meeting was statutory duty of the directors. According to the commercial code of Ethiopia such meeting has to be conducted within four months from the end of financial year.²² But directors of that company did not conduct the meeting according to the given provisions. The commercial code states that the share holders have to have copies of balance sheets and profits and loss accounts, reports submitted by the directors and by the auditors to general meetings for three preceding financial years but the shareholders of that company did not obtain the chance of having any of such documents. Directors, therefore, had failed to exercise their duty and be liable criminally because they breached statutory provision and they are also liable civilly for negligent act.

Notes

¹Harry C. Henn, Laws of Corporation 3rd ed (New York, West Group 1983) P. 612

² ibid

³ K.C/ Garage, Company and secretarial practice 2nd ed (Ludhiano, Kal Yani Publisher 2002) p. 402

⁴Harry C. Henn Laws of Corporation 3rd ed (New York, West group 1983) p. 625

⁵ Civ. C. Art 2208

⁶Comm. C. Art 355

⁷ Civ. C. Art 2211(1)

⁸ Stevens Private corporations 2nd ed (Paul minn, west Publishing Co. 1949) P. 627

⁹ Comm. C. Art 356(1)

¹⁰ ibid C. Art 356(3)

¹¹ ibid

¹²ibid Art 356(5)

¹³William E. Knepper, Liability of Corporate Officers and Directors. (Indiana Police, the Allen Smith Company, 1969) P. 33

¹⁴ Civ. C. Art 1751



¹⁵ K. C. Garage, *Company and Secretarial Protect* 2nd ed
(Ludhiano, Kalyani Publisher 2002) p. 404

¹⁶ Stephen Griffin, *Company Law: Fundamental Principles*
3rd ed (London, Pearson Education Limited, 1991) P. 260

¹⁷ H. R. Hahlo, Company Law through the Cases 2nd ed.,
(Cape Town, Juta & Company limited 1996)p. 34

¹⁸ Comm. C Art 364 (3)

¹⁹ Comm. C. Art 358(1)

²⁰ *ibid* art 358(2)

²¹ Harry C. Henn *Laws of Corporation* 3rd ed (New York, West
Group, 1983) p. 565

²² Comm. C. Art 418(1)

VI. Conclusion and Recommendations

Essentially, company is a group of natural or legal persons coming together voluntarily to carry on certain business by organizing themselves into a single legal entity with a view to function in an artificial person in the eyes of law. In commercial code of Ethiopia, we don't find such distinctive nature of company form of business organization. Under this code we find both company and partnership are formed by partnership agreement and have legal personality.¹

Nowadays, companies are institutional more than contractual relations. In contractual agreement the withdrawal of any party may result in the modification or termination of the contract. But in a company form of business organization change or death of any shareholders may not result in the change of constitution of the company. Further more, shareholders can not decline to apply majority vote by raising that they did not contract or agree to the majority decision. The code does not show such distinction between company and partnership.

Both company and partnership are legal entity under commercial code of Ethiopia. But important effects of legal

personality such as "distinctiveness" and "succession" are not applied to partnerships.

In company form of business organization shareholders and company, are distinct from each other. Even though, partnership is legal entity, liability that comes to the partnership is met by partners personally, jointly and severally. So, there is no distinctiveness between the partnership and the partners.² The liability of the partnership passes to the partners who constitute the partnership.

On the other hand, in case of company, change or death or being legally incapable of members can not be the ground for dissolution.³ There is perpetuity or succession of the company. While death, incapacity and bankruptcy of the partners cause the dissolution of the partnership.⁴

The very idea of partnership is the coming of together of few members who have personal elements such as intelligence, capacity, behaviors etc. It is these elements that matters. Where the business organization is company, especially Share Company, it is capital contribution that matters rather than personality. Because of these characteristics of partnership, the number of partners in partnership is few. For instance in Indian law the

number of partners can not exceed ten in banking and twenty in other types of business organization⁵ partners contribute their contribution not only in money or property but also their own efforts.⁶ The liability of the partnership is also unlimited which devolves to the partners who are co-owners of their property in the partnership.⁷ Because of these factors, it is very difficult to manage partnership when the numbers of partners are very great. However, under commercial code of Ethiopia the maximum number of partners in partnership is not fixed. It is the opinion of the writer that maximum number of partner in partnership is to be fixed.

Classification of partnerships and companies are not well developed under commercial code of Ethiopia. In common law system and in French company law there is civil and commercial partnership⁸ commercial partnership is a partnership which carries on commercial activities while civil partnership carries on non-commercial activities such as club, research association or societies promoting various objectives.⁹

Commercial code of Ethiopia Art 213 states that "any business organization other than an ordinary partnership may be a commercial business organization" and further states that if ordinary partnership carries on business it shall be deemed to be

number of partners can not exceed ten in banking and twenty in other types of business organization⁵ partners contribute their contribution not only in money or property but also their own efforts.⁶ The liability of the partnership is also unlimited which devolves to the partners who are co-owners of their property in the partnership.⁷ Because of these factors, it is very difficult to manage partnership when the numbers of partners are very great. However, under commercial code of Ethiopia the maximum number of partners in partnership is not fixed. It is the opinion of the writer that maximum number of partner in partnership is to be fixed.

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Commercial code of Ethiopia Art 213 states that "any business organization other than an ordinary partnership may be a commercial business organization" and further states that if ordinary partnership carries on business it shall be deemed to be

general partnership.¹⁰ From these provisions one can conclude that ordinary partnership is designed to carry on non-business activities. But if it has to carry on business activities it is treated as general partnership, i.e. partnership which carries on business organization.

Furthermore, Art 280 (2) states that "where the partnership is commercial partnership....". This impliedly indicates that general partnership can be either commercial or non-commercial (i.e. civil partnership)

Thus, we can say that there is a classification of partnership into commercial and civil partnership. But the classification is indirect and not clear. It is the opinion of the writer that this classification has to be made clear and be developed.

Earlier we have said that companies are also classified into commercial and civil companies. However, no such indication is found under commercial code of Ethiopia under this code all companies are commercial companies.¹¹

Though there is a sign of classification between public and private company, it is difficult to say that there is such classification under this code. Classification of company by share and guarantee is also not known under commercial code of

Ethiopia. It is writer's opinion that such introductions have to be made to companies under commercial code of Ethiopia.

In this text, we have seen that board of directors is the supreme organ in the management of Share Company. The commercial code of Ethiopia also states that "only members of a company may manage the company".¹² But there is no method as to how the directors strongly manage the company. Theoretically, it is assumed that Share Company is managed by the board of directors, but in reality the power of management is in the hands of general manger and chairman of the board. Practice shows that the role of the board of directors is often limited to one of control rather than managing.

Nowadays, there are two approaches which are designed to strength the role of board of directors to execute its managerial functions. One is the common law approach. In this legal system one or more directors are assigned as a "managing director". Such director is entrusted with substantial powers of management.¹³ Accordingly, managing director is policy maker as well as implementer.

The other approach is the one adopted by French company law which is said to be taken from German law.¹⁴ In French company law companies are managed by

1. Board of directors or
2. Executive board and supervisory board.

The first one is traditional method of management of company which is currently exercised under commercial code of Ethiopia. The second one is new development introduced in French company law in 1966.¹⁵ Accordingly, company is managed by two types of boards. One is supervisory whose function is to control the company. Members of this board are shareholders. The second one is executive whose function is to manage the company. Members may or may not be shareholders. The preference of the writer is to adopt unitary board of the common law system since it is less expensive and easily be applied.

Qualification of directors is the other point that is to be considered. According to commercial code of Ethiopia holding of some nominal number of shares is the only qualification that qualifies the post of directorate. This is insufficient qualification for a person who manages the company. The business of the company is also in the hands of the directors. The success of the company is

in hands of the directors. Therefore, shareholding alone should not be the only qualification for directorate. Educational and entrepreneur background, managerial experience, age limitation etc are to be introduced to commercial code of Ethiopia.

Furthermore, it is important that training provisions should be available for directors. Relevant experience and training should be fundamental for directors. Directors are not only appointed to control but also to manage the company, which needs up-to-date knowledge of management.

Duties of directors are the area where the commercial code of Ethiopia had become confusing. Art 362 of the code's heading is "duties of directors". Further, it states that "in addition to their duties under Art 364" and Art 364's heading is "liabilities of directors to company". The code mixes duties of director with liabilities of directors. Basically both Articles are different. Duties of directors are acts that they are ought to do, while liability is the sanction upon directors when they failed to fulfill their duties and powers according to the law and regulations.

Art 362, though, provides its heading as "duties of directors" it deals with small and insignificant points such as keeping regular records and accounts, which are of less important. The most

important duties such as "fiduciary duty", "duty to care and skill", "duty to attend board meeting" are not mentioned in this Article. In addition, director's duty is to act in the interest of their company, shareholders and also have to take account of other interests such as third parties, employee and customers. So, it is writer's opinion that directors' duty should be clearly provided, incorporating all necessary elements mentioned here in above.

In the text of this thesis we have said that board of directors is supreme and original authority in matters of regular business management. We have also seen that powers are given to the directors either specifically from time to time i.e. restrictive approach or liberal approach.

Though commercial code of Ethiopia adopted the restrictive approach, Art 363 of the commercial code which is supposed to state powers of directors, states the source of powers of directors. According to this Art source of powers are the law, memorandum of association, articles of association and resolution of general meeting of the shareholders. The last three sources of power are sources that emanates from shareholders. It is powers that vested in the shareholders. The first one is law as a source of power. But the powers that should have been given to the directors are not

provided in the commercial code of Ethiopia. In chapter three of this thesis we have seen that the code has adopted restrictive approach. In restrictive approach, powers are restrictively divided between the board of directors and general meeting. But such power has not been given in the code. The powers that should have been given in the commercial code are the minimum standard of powers of directors, which are applied up on all companies. Such statutory powers are used as guidance for every company. It is a means of legal regulation which will bring company management to the minimum standard of uniformity. So, it is the opinion of the writer that restrictive powers stated in chapter three of this thesis be adopted by commercial code of Ethiopia.

The last point is liability of directors. Directors are liable to the company and third party. They are liable both in civil and criminal law. Civil liability includes negligence, breach of trust and ultra vires. Criminal liability also includes false statement, breach of trust etc.

Under commercial code of Ethiopia directors are liable to the company and creditors pursuant to Art 364 and 366 respectively. Directors are responsible to the company for exercising the duties imposed upon them with due care as it is expected from all

agents.¹⁶ But we have just discussed duties of directors are not clearly provided under the code. So, how can directors be responsible under unknown conditions?

Directors are also liable to the third party when they failed to maintain intact the company assets.¹⁷ Of course, this is the most important point for which directors should be liable. But this is not the only area of liability. There are other areas which bring damages to the third party. Such as misstatement in a prospectus which will induce a person to subscribe for shares in the company, failure to repay application money for shares where the minimum subscription as stated in the prospectus has not been subscribed etc. Liability will occur where directors are negligent, breach of trust and perform outside of the scope of the company. Such failure has not been known to the code.

The code also does not clearly state that liability of directors are both criminal and civil liabilities. That is why in the court case analyzed we did not observe criminal liability. What we have seen was only civil liability. Criminal liability was missed.

It is writer's opinion that elements that make liability of directors should clearly be stated and liabilities of directors are both criminal and civil.

Notes

¹Comm. C. Art 210

² ibid Art 280(1)

³Comm. C. Art 542(3)

⁴ Comm. C.art 295 cum 260

⁵Gangadhara Rao, Industrial Organization (New Delhi, Kaniska Publishing House, 1983) p. 64

⁶Comm. C. art 229(1)

⁷ Harry C. henn Laws of Corporation 3rd ed (New York, West group, 1983) p. 61

⁸ jean Pierr Le gall, French Company Law 2nd ed., (London Long Man Group, 1992) p. 7

⁹ Keith Abbot, Company Law 2nd ed. (Guensey the Guensey press Company Ltd, 1987) p. 49

¹⁰ Comm. C. Art 2123(2)

¹¹ Comm. C. art 10

¹² ibid C. Art 347(1)

¹³ K. C. Garage, Company and Secretarial Practice 2nd ed (Ludhiano, Kalyani Publisher, 2002) p. 428

¹⁴ jean Pierr Le gall, French Company Law 2nd ed., (London, Longman Group, 1992) p. 98

¹⁵ ibid

¹⁶ Comm. C. Art 364(1)

¹⁷ comm. C. Art 366(1)

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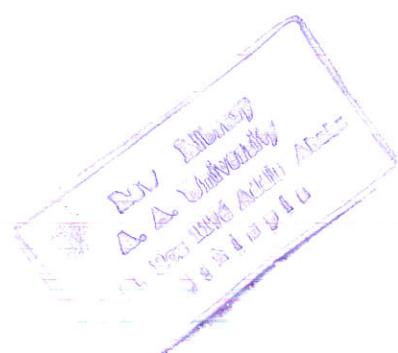
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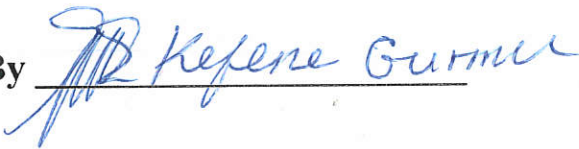
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DECLARATION

The thesis is my original work, has not been presented for a degree in any other University and that all sources of material used for the thesis have been duly acknowledged.

By  Keferne Gurmu

Advisor 

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Berhane Ghebray (Dr.)