The New Ethiopian Commercial Code: A Highlight of Major Changes

By: Fekadu Petros
Fekadu Petros & Partner Law Office
27 March 2021

On March 25, 2021 the Ethiopian Parliament adopted the Revised Commercial Code. It was a historic development, as the revision of the Code has been on the list of laws to be revised for over three decades. The 1960's Commercial Code, which was advanced for its age at the time of making, was found to be lacking in many important respects. The foreign Commercial Code based on which the code was originally drafted had undergone many rounds of revisions leaving the Ethiopian code lagging behind not only relative to the time, but also from comparator country codes. The revision was indeed, long overdue.

However, the new commercial code did not completely change everything from the old, though there are many important changes introduced. The most profound change is the division of the hitherto code into commercial code and financial services code. Thus, Book I (on traders), Book II (on business organizations) and Book V (on bankruptcy) of the old code are now enacted as Commercial Code. Book III (on carriage &insurance) and Book IV (on banking and negotiable instruments) from the old are to be separately promulgated as Financial Services Code-in the future. This work is still in progress, and the old commercial code will remain in force in relation to Book III and IV, until the Financial Services Code is approved by the Parliament.

Book II on business organizations has undergone some fundamental and mostly liberal changes. The most notable changes are: abolition of the ordinary partnership; introduction of limited liability partnership, and one member company as new business vehicles; the permission of outside/non-shareholder directors; abolition articles of association as an incorporation document; the introduction of supervisory board; improvement of minority shareholder protections; clear provisions about board of directors for PLCs; and regulation of group of companies.

Let us see each of these changes in brief summaries.

1. Ordinary partnership is expunged

The law on ordinary partnership has been deleted entirely. There has always been confusion as to the nature and purpose of an ordinary partnership. The confusion emanated from the characterization of ordinary partnership as a non-commercial business organization. If so, its inclusion in the old code from the outset was problematic. This debate was more pedantic than practical, as the business world didn't use the ordinary partnership as an organizing vehicle. This justifies its deletion.

2. Limited liability partnership (LLP)

While the ordinary partnership form of business organization is deleted, a new form of partnership is introduced-***the limited liability partnership (LLP)***. This form of business vehicle combines the advantages of partnerships and companies, i.e., simplicity of partnerships and the advantage of limited liability from companies. It is however not open for all types of businesses/investors. It is reserved for professional businesses, i.e., businesses requiring professional qualification such as auditing, legal service, architecture, and so on.

3. One member company allowed

Another important novelty about the new commercial code is the introduction of one Member Company- a practice popular in other countries. Under this new law the one-member company should be in the form of a PLC-not a share company. This change solves the age old problem of bonding with a partner for the sole reason of meeting the minimum number of two shareholders. The resulting associations often were unnatural and served no purpose except the pretense. The problem was even more challenging for foreign investors who must find partners from local investors for non business reasons. Often, the companies are run as one member Company, and there was no meaning in requiring a minimum of two members. Now, it is permissible to set up a one person limited liability company. The only prohibition is that the sole shareholder cannot itself be a PLC-Article 539. There seems no prohibition against other forms of business organizations (Share companies, LLCs) to set up a one member company.

4. Outside/non-shareholder directors allowed

One of the problems of the old code was the requirement that members of the board of directors be shareholders. While, the rationale was to ensure alignment of interest between shareholders and directors of a company, it was a strict mandatory provision that denied companies the benefit of recruiting professionals as board members. The requirement of owning shares is now eliminated. A person can be a board member without owning its shares. But the maximum number of such outside board members cannot exceed one third of the size of the board. Thus, the practice of assigning shares to outsiders for the purpose of making them eligible for board seats is not an obligation any more.

5. Supervisory board of directors is permissible

A change with no apparent justification is the introduction of a supervisor y board. This means companies can now have two boards: executive board and the supervisory board. It is not clear what improvements the increase in the layers of control will bring into corporate governance. The downside is that this may distort the power and liability distribution among the corporate governance organs. Where does the ultimate power and liability rest between the executive and the supervisory board is not clear. The good thing is that this is not a mandatory requirement. Only companies that want to organize their boards into two layers can do that. Others that do not see merit in this may keep with the unitary board. Interestingly, the revised code doesn't introduce mandatory employee representation in the board-a practice often associated with the two tiered board, though it allows up to 1/3rds of the board to be composed of executive officers.

6. No-articles of association required for incorporation

The hitherto requirement of two incorporation documents- the memorandum of association and the articles of association is now abolished. Incorporation will be effected by the memorandum of association alone together with other documentations. In practice the two document requirement served little purpose as incorporators often reproduced the same instrument with two names. This will make company formation simpler. Some questions remain for practitioners, regulators and courts. What will be the status of the

articles of associations of companies from now on? The Code doesn't answer this question. But going forward, companies have to re-register a unified MOA incorporating provisions of the articles of association, or the articles of associations up until this law will remain valid indefinitely.

7. Improvement in minority shareholder protections

For many years Ethiopian law remained rather weak in terms of protecting minority investors in companies. This new commercial code introduces remarkable improvements in this regard. From the FDI promotion perspective, the desire of improving the doing business rank was the major impetus behind these change. Thus, there are fingerprints of the World Bank *Doing Business* program in these changes. Some of these changes are the following:

- *Article 292: New provision on mandatory bid- under this provision when a single shareholder acquires 90% or more of the shares of a company, a minority shareholder can compel such controlling shareholder to buy his/her shares at a price proposed by the minority shareholder or failing agreement, at a price fixed by an expert appointed by the court.*

- *Article 328: The right to institute action against directors- Ethiopian law doesn't allow derivative suit by shareholder on behalf of the company. This provision requires that in principle the shareholders' meeting should adopt a resolution for prosecuting directors for any alleged damages they inflicted against the company. If the company's shareholders' meeting fails to pass the necessary resolution, or if the company fails to institute proceedings after the shareholder resolution to do so, shareholders representing 10% of the shares can institute the action. It was 20% in the old code.*

- *Article 351- minority shareholders representing at least 10 of the share capital can request the auditor of the company to convene a general meeting of shareholders. This is an improvement from the 20% in the old code. It gives minority shareholders important control, given that shareholders owning 20% shares can appoint a separate auditor.*

- *Article 366(3)-Only 5% shareholding is enough to request the court to order the convocation of a general meeting of shareholders. It was 10% in the old commercial code.*

- *Article 381 & 382-access to documents:- the biggest obstacle for minority shareholders is accessing documents to prove suspicions of mismanagement. The old code allows limited set of documents such as audit reports, attendance sheets,*

shareholder lists, and minutes of resolutions. But the new code includes the list of related parties, compensation paid to executives, and copies of suspected transitions - Article 328(4).

- *Article 396-special inspection/audit:-shareholders representing 10% shares can request the company or the court to appoint a special inspector to investigate certain transactions which they suspect to be harmful to the company. Where the request is made to the court, the court has to instruct the company to make such an expert appointment.*

8. A board of directors for PLCs

In the past organizing the management of a PLC into a board of directors was clear. Some notary officers allowed and others refused to register PLC incorporation documents containing provisions for board of directors. The uncertainty created in this area meant that most incorporators shied away from the practice. Now the law has clarified the possibility, and the number of directors and the manners of appointment, removal etc, is also regulated. This is a welcome development and a liberal reform.

9. Regulation of group of companies

There are extensive provisions on group of companies making a clear break from the old code. The law defines a group as an economic entity comprising a parent company and both domestic and foreign subsidiaries. It also defines the terms parent company, subsidiary company, wholly owned subsidiary, control, and so on. It defines the maximum amount of cross-holding between two companies, and recognizes parent companies power to instruct its subsidiary. It also regulates protection of minority shareholders of the subsidiary company, taking of business opportunities of the subsidiary by the parent, etc. What this law does is recognition of group of companies and regulating certain governance practices. Otherwise, the practice of corporate grouping existed in Ethiopia for a long time.