Statutory Protection of Creditors of a Subsidiary Company under Ethiopian Law: A Case for Parent Company's Liability for the Debts of Its Subsidiaries

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Abstract

A corporate group consists of a parent company and subsidiary companies with separate legal personality. A corporate group can have a dominant influence and may drain the assets of member companies toward the parent company, threatening the interests of minority shareholders, and creditors. To safeguard these interests, statutory provisions or self-help mechanisms should provide protection. This article examined the legal frameworks provided by Ethiopian laws for safeguarding the creditors of subsidiary companies in corporate groups. Specifically, it emphasized the question of whether the parent company is liable to a subsidiary company's creditors. The Ethiopian Revised Commercial Code (RCC), the primary legislation governing corporations in Ethiopia, establishes general regulations on the protection of creditors of businesses. This article explores the liability of a parent company towards the creditors of its subsidiary under the RCC and other relevant Ethiopian legislations. It uses German Law and the UK Company Act for comparative discussions. Italian law is also consulted. The study reveals that the RCC has provisions which prohibit parent companies from abusing control over subsidiaries. The provisions are related to wrongful trading, abuse of group's interests to the detriment of its subsidiaries, and cross-holdings of shares above the legal thresholds. These provisions provide statutory protections to creditors of a controlled company in a corporate group. Violations of these prohibitions by a parent company

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can lead to different degrees of liability towards creditors of a subsidiary company.

Keywords: *Contractual Creditor; Corporate Group; Parent Company; Subsidiary Company; Liability; Ethiopia.*

1. Introduction

Companies can form groups, resulting in complex corporate groups operating in large, medium, and smaller enterprises. Countries have attempted to address these developments through legislation, either through general company law, specific laws for affiliate companies, or judicial practice.[1] Corporate law posits that corporations have separate legal personalities and limited liability for shareholders, forming the corporate shield[2]. This shield applies to all corporate groups, meaning a parent company is typically not liable for the unpaid debts of its subsidiaries.[3] Traditionally, company law aimed to provide statutory protections to third-party creditors, but corporate groups have unique organizational structures and management, making the concern of creditor protection more serious.[4] This concern was justified by the

[1] Mehamed Aliye Waritu, Affiliate Companies in Ethiopia: Analysis of Organization, Legal Framework, and Current Practice, LLM Thesis, AAU (2010), P. 28.Availablr at; http://etd.aau.edu.et/handle/123456789/14933 (Accessed Aug. 3, 2023.) Despite the variation in the modes and objectives of regulations, the corporate laws of virtually all countries do regulate companies. One of the notable rationales for regulating single companies as well as corporate groupings by corporate laws is the issue of the protection of creditors.

[2] Hesty Deyah Lestari ,Creditor Protection Within Corporate Group Insolvency, *Mimbar Hukum* ,Volume 25, Nomor 1, Februari 2013, p-1, Available at; https://jurnal.ugm.ac.id/jmh/article/view/16104; Accessed on June 11-2023

[3] Frankel, Tamar, Book Review, Company Systems and Affiliations , American Journal of Comparative Law, 1988, Vol.36, No.1 p.163, available at https://www.jstor.org/stable/i234830, Accessed on March-14, 2023

[4] Mads Andenas and Frank Wooldridge, European Comparative Company Law, 2009, p-448, Available at, https://www.cambridge.org/core/books/european-comparative-company-law/6696387D0A03A2E8E6A1C41112557D75; Accessed on June 03-2023

trend of establishing affiliate companies for the limited liability of parent companies in risky activities.[5]

Previous studies on the topic of the protection of creditors in companies under Ethiopian laws reveal that the statutory mechanisms adopted, especially under the Old Commercial Code[6] were inadequate in effectively protecting corporate creditors when seen through the lenses of modern corporate governance and company law principles.[7] One may wonder to that extent that situation has changed following the legislative moves including the enactment of RCC, which has introduced new provisions on business organizations, . One key change introduced by the RCC is the recognition and regulation of corporate groups, which was not legally recognized and regulated until the RCC of 2021.[8] The RCC aims to protect corporate creditors, but Title Ten, Chapter One of the RCC[9] (Arts. 550–564) contains lesser provisions pertaining to creditors' protection in the context of corporate groups when compared to provisions that aim to protect creditors of companies not in corporate groups. Thus, it is imperative to refer to the legal provisions concerning creditors' protection placed under other sections of the RCC.

The article analyzes the statutory protections of a subsidiary company's creditors in Ethiopia's corporate group laws focusing mainly on vertical groupings. To this end, it analyzes the RCC and other domestic laws, with

[5] Mehamed, *supra note* no-1, p-28

[6] Commercial Code of the Empire of Ethiopia, 1966, Negarit Gazzetta, Extraordinary Issue, Proc. No. 166, 19th year, No. 3

[7] Tigist Dessie, The Protection of Corporate Creditors under Ethiopian Share Company Law in Light of International Recommendations, LLM Thesis, Unpublished, Bahirdar University, 2020, Available at: https://ir.bdu.edu.et/bitstream/handle/123456789/11927/TG%20final%20paper.pdf?sequence=1&isAllowed=y, Accessed on June 3, 2023.

[8] Title Ten ; Chapter One (art-550-564) of the RCC.

[9] The Commercial Code Proclamation No. 1243/2021 *Federal Negarit Gazette* Extra Ordinary Issue (2021) (the Revised Commercial Code' /RCC here in after).

some foreign jurisdictions consulted for comparative insight. Ethiopia follows the German model and incorporates elements from the UK Company Act.[10] Italian law, as one of the national jurisdictions with developed corporate group laws, is also consulted. The primary source is the law, while secondary sources include books, journal articles, and web pages.[11]

The article is organized as follows: Next to this introductory section, Section 2 highlights corporate creditor protection and corporate groups in general. Section 3 appraises a parent company's potential liability towards creditors of its subsidiaries. Finally, the article provides a brief conclusion and recommendation.

2. General Overview of Corporate Group: Definition, Nature, and Parent Company's Control Right

A corporate group that involves the management of two or more businesses as a unified economic entity, each with its own limited liability and legal identity, has now become a global phenomenon.[12] Such a group can be referred to as parent-subsidiary companies, holding-subsidiary companies, or affiliated companies. The organization of companies into groups offers numerous benefits, such as reduced tax obligations, accounting concerns, and increased flexibility in debt financing.[13] They also promote organizational

[10] Mesfin Beyene, Regulation of Groups of Companies in Ethiopia: A Comparative Overview, Mizan Law Review, Volume 17, No. 1, (2023), P. 210.

[11] The main basis of analysis will be the relevant laws pertaining to the issue of corporate groups in Ethiopia, including the RCC, Commercial Registration and Licensing Proclamation No. 980/2016, Capital Market Proclamation No. 1248/2021, and other relevant items of legislation. Foreign and domestic literature on the issue was also consulted as secondary data.

[12] Thomas Hadden, *The Control of Corporate Groups*, London Institute of Advanced Legal Studies, University of London, 1983, p. 343–369. Also see Paul L. Davies*, Introduction to Company Law*, Oxford University Press, 2002, *P.* 103.

[13] Eílis Ferran, *Company Law and Corporate Finance*, Oxford University Press (1999*), P. 533*

flexibility and minimize liability by shielding certain firm assets from legal action.[14]

In Ethiopia, the Ethiopian Commercial Code of 1960 lacks a specific regime for corporate groups, and previous studies have criticized the lack of special laws governing them in Ethiopia compared to many foreign jurisdictions.[15] Recently, issues related to corporate groups have come under regulation from a range of laws like the RCC, financial market regulations, and bankruptcy laws. Hence, to address legal issues pertaining to corporate groups, it is essential to skim through these scattered provisions. The RCC defines corporate groups as sets of companies including the parent company and all its subsidiaries.[16] A subsidiary company is a company subject to the control of the parent company, either directly or indirectly through another company.[17] The parent-subsidiary relationship between companies is created when there is direct or indirect control over one company by another.[18] The Capital Market Proclamation[19] also defines a subsidiary company as any company owned or controlled by another company.[20] However, the proclamation only talks about a subsidiary company of a share company, focusing on the relationship of parent-subsidiary established when one share company is

[14] Eike T. Bicker, Creditor Protection in the Corporate Group, (July 2006), p. 1, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=920472, (Accessed March 6, 2024).

[15] The research reviewed for the purpose of this study addressed the problem of the lack of regulation of corporate groups under the old Commercial Code. And there were pertinent recommendations to accommodate the issues of corporate groups in the RCC.

[16] RCC, art. 550 (1).

[17] Id., art-550 (2).

[18] Id., art-550 (3).

[19] Capital Market Proclamation No. 1248/2021, *Federal Negarit Gazette*, 27th Year No. 33 Addis Ababa, 23rd (July, 2021).

[20] Id., Art. 2/74.

owned or controlled directly or indirectly by another share company.[21] The RCC focuses on the control aspect, while the proclamation emphasizes management by the holder. These two provisions differ in their focus on ownership and control aspects. Another point of divergence between the two legislations is that the proclamation, instead of using the RCC's expression of *'subjected to the control of another company',* provides more qualification by stating '*owned or controlled directly or indirectly by another share company.'* Thus, the proclamation emphasizes the relationship of parent-subsidiary that would be established when one share company is owned or controlled directly or indirectly by another share company. The ownership aspect does not vividly stand in the definition of the RCC as such. Instead, it has preferred to address the control aspect.[22]

The Commercial Registration and Business Licensing Proclamation[23] also defines a 'holding company' as '*a company incorporating two or more limited liability companies and issued with a special registration certificate and managed by the holder.'*[24] Let us compare of this definition with the definition for parent-subsidiary relations contained in the RCC: the former emphasizes management by the holding company while the RCC states that "comprising a controlling power" is an essential element for a parent-subsidiary relationship to exist.[25] This is where these two provisions clearly

[21] Id, Art. 2/13 defines the term 'company' as 'a share company as defined in the RCC'. This partly arises from the scope of application of the proclamation since the issuance of shares to the public is not allowed for other forms of companies except for share companies.

[22] Of course, it is to be noted that one of the tools by which one company potentially controls the other is through the ownership of the majority of shares.

[23] The Federal Democratic Republic of Ethiopia, Commercial Registration and Licensing Proclamation No. 980/2016, *Federal Negarit Gazette* No. 101 (5 August 2016).

[24] Id, art-2/40, And, pursuant to Art. 9 of the RCC, a holding company is a parent company that does not itself conduct operations to produce goods or render services by engaging in activities specified under Article 5 of the Code but holds shares in other companies that do so.

[25] Mesfin, *supra* note no.10, P. 202.

differ.[26] On the other hand, the RCC defines 'control' as a parent company's ability to govern the financial and operating policies of a subsidiary, either alone or with other shareholders.[27] Under the RCC, control exists when a company owns shares with voting rights representing more than half of the capital in the subsidiary.[28] However, ownership of more than half of voting rights in a company by another does not necessarily establish a parent-subsidiary relationship. In exceptional circumstances, the legal effects of 'control' may not apply.[29] A parent-subsidiary relationship can exist even when one company owns less than half of voting rights, especially when shareholders other than the shareholder company are not in a position to exercise control over their company. The RCC's Art. 553/1 mandates that a parent company's voting rights in a subsidiary's controlled company must include subscription and purchase rights for exercisable or convertible voting rights. A subsidiary company that has no other shareholders than a parent company is considered '*a wholly owned company*'[30] The RCC outlines that, in Ethiopia, the most common method for forming affiliation is acquiring a company's share, either as a share company or an investment in an existing company's share capital. This can be a one-sided or a joint holding.[31] Other methods include control agreements, management contracts, and business leases.[32] Affiliation can also be established through voting agreements or

[26] Id.

[27] RCC, art. 552(1).

[28] Id., Art. 552(2).

[29] Id.

[30] Id, Art-551.

[31] In most national jurisdictions, where one company acquires 10 percent or more of another company's share that other company is prohibited from owning or holding shares in the first company. Also see; Mehamed, *supra note* no-2, P. 20.

[32] Immenga Ulrich, *Company System and Affiliations*, International Encyclopedia of Comparative Law, Martinus Nijhoff Publishers, The Hague, Vol.XIII (1985) P. 5.

shares with multiple or no voting rights.[33] In cases of no controlling interest, various techniques can be employed to obtain sufficient voting power.[34]

A parent company can exercise control by giving instructions to its subsidiary, potentially affecting its interests and liabilities towards shareholders and creditors, as per Art. 556/1 of the RCC. A parent company is entitled to give instruction to the organs of management of its subsidiaries while acting as a shareholder in the general meeting of shareholders or through its board of directors or senior management.[35] However, the extent and mode of the instructions is unclear. The law simply stipulates that instructions from a parent company may be given "to the organs of management of a subsidiary company".[36] Since a subsidiary company must have all of the necessary management organs in accordance with the RCC, it is unclear in this case whether orders from a parent should be provided to all of the organs or, instead, just one of the organs. In a similar vein, the law says nothing concerning the way instructions are to be given (written or spoken). A parent company may request access to information from a subsidiary under the RCC in order to provide effective instructions.[37] Undoubtedly, this entitlement can be seen as an extension of shareholders' access to information as specified under the general provisions of the RCC. The board of directors or other management body of the parent company may request any information from the subsidiary in accordance with Article 557 of the RCC, with the exception of communications that infringe upon the rights of third parties or foreign laws.[38] Once again, the law is ambiguous regarding which

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[33] Id.

[34] Id.

[35] RCC, art-556/1.

[36] Id.

[37] Id, Art-557.

[38] The right to request information from the subsidiary company, in the words of the RCC, is available to the board of directors or ‘a management body with equivalent status’ of a parent company. "A management body with equivalent status" may refer to a parent company that

organs of the subsidiary company must give requested information and what happens if they are unable or refuse to comply.

3. The Concept of Corporate Creditors' Protection in Company Law: An Overview of Rationales and Mechanisms of Protection

Creditors lend money to a company at will, making it a debtor to them. However, companies often disappear without returning money, leading to significant losses for creditors. Traditionally, there were no laws to provide remedies for creditors involved in a company's failure.[39] In the modern times, governments have enacted laws to curb such practices and protect creditors' interests.[40] The laws also aim at striking a balance between the interests of shareholders and creditors.[41] Particularly, company laws regulate Corporate Groupings (CGs), most importantly, to protect minority shareholders and creditors of member companies, as dominant groups can hamper creditors' interests. The latter two are arguably more susceptible to the opportunism or negligence of the dominant shareholders in the framework of a corporate group than they would be in the context of a single company.[42] CGs have a chain of control, where each company has its own legal personality and is not liable for another's debt.[43] This can lead to a loss of corporate economic

is a private limited company or a one-member private limited company that is exempt from the requirement of having a board of directors as its organ of management.

[39] Richard A. Posner, the Rights of Creditors of Affiliated Corporations,University of Chicago Law Review, V-43, 1975, p-502, Available at; https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2856&context=journal_articles, Accessed on Aug-5-2023

[40] Id.

[41] Mads Andenas and Frank Wooldridge, *European Comparative Company Law*, Cambridge University Press. (2009), P. 448

[42] Hertig, Gerard, and Kanda, Hideki, "Creditor Protection," in R. Kraakman et al. (eds.), *The Anatomy of Corporate Law*, Oxford University Press (2002), P. 74.

[43] Mehamed, *supra* note no. 1, P. 26.

independence in companies affiliated with other companies, posing risks to creditors.[44]

The stronger concerns in corporate groups for the protection of creditors emanate from their nature.[45] Corporate groups are, on the one hand, collections of independent companies; on the other hand, one could be dependent on the other, and the other could control the dependent.[46] This nature of CGs may hinder creditors from getting performance from controlling companies due to the legal entity doctrine or principle of limited liability.[47] The application of separate entity and limited liability principles makes the liability of the parent company for the debts of its subsidiary limited to the amount of its shareholding in the subsidiary, even though in commercial reality, corporate groups are designed for the interests of the group as a whole.[48] In corporate groups, each company has its own legal personality, and legally speaking, one company is not liable for the debt of another company.[49] In addition, economically, corporate groups often do not operate independently of each other because of the chain of control among them. Due to this chain of control, there is a wider possibility that a controlled company may be used to pursue the economic interests of the group rather than its own interests.[50] Hence, in that case, creditors of the controlled company may not get the performance of their obligation from the company not pursuing its own interest, and because of the legal entity doctrine, they could not easily go against the other member company in whose interest the debtor company was working.[51] So, the risk to creditors is either in the

[44] Id.
[45] Id, P. 26.
[46] Id.
[47] Id.
[48] Lestari, *supra* note no-2, P.1.
[49] Tamar, *supra* note no-3, P.163.
[50] Mehamed, *supra* note no. 1, P 28.
[51] Id.

principle of limited liability or in the loss of corporate economic independence in companies affiliated with other companies, the creditors of the controlled company.[52]

Ethiopian affiliate companies are becoming more prevalent in both financial and non-financial sectors. These companies often involve private limited companies, family relations, common management, common shareholders, and cross-shareholding.[53] However, previous studies show that the statutory mechanisms used, particularly under the old Commercial Code, are inadequate for protecting corporate creditors.[54] The recent enactment of the RCC of 2021 has introduced new provisions for business organizations, including the recognition and regulation of corporate groups. Owing to its newness, there is an inadequacy of studies and judicial practices on the issues of corporate groups in Ethiopia, let alone separately on the creditors' protection aspect. Hence, this work, instead of addressing all the potential concerns in corporate groups in general, has critically analyzed the provisions of the relevant Ethiopian company laws on the protection of creditors of subsidiary companies subject to the direction and supervision of another company, i.e., a parent company, in vertical groupings of companies. It has also analyzed the relevance of the rules on creditors' protection, speculating mostly for the protection of creditors in single companies to safeguard corporate creditors' interests in corporate groups.

Corporate creditors can use various protection mechanisms to ensure their claims are met by debtor companies.[55] These mechanisms can be statutory legal provisions in company, insolvency, and other laws, or through a self-

[52] Id.
[53] Id.
[54] Tigist, *supra* note 7.
[55] Id., p. 35.

help mechanism.[56] However, there are no uniform approaches across jurisdictions. In Anglo-American traditions, creditors are protected through contracts, while in civil law countries like Europe, they are protected through statutory provisions.[57] This is partly attributable to the major objective of company laws in these traditions, which is the maximization of shareholder value, justifying maximum flexibility for private regulation through contracts.[58] Contrastingly, in civil law countries such as Europe, creditors are usually protected through statutory provisions, as the company law in these traditions also seeks to protect creditors as well.[59] Generally, there are two categories of mechanisms recognized in many jurisdictions: statutory mechanisms and contractual mechanisms.[60] Statutory protection is incorporated in company law, insolvency law, and common law rules on lifting the corporate veil.[61] It is efficient for bargaining between companies and creditors, as it is less costly.[62] Legal rules that provide incentives and remedies include fraudulent conveyance law, lender liability, legal capital rules, and fiduciary duties to creditors.[63] Detailed discussions on each

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[56] Elis Tarell, Basel II, and the Protection of Creditors in Company Law: The Role of Banks as Financial Intermediaries in the Protection of Third Creditors of Debtor Companies, Ph.D. Dissertation, Hamburg University, (2015), p. 47 https://d-nb.info/1127225545/34 (Accessed June 23, 2023).

[57] Id.

[58] Id.

[59] Id.

[60] Id.

[61] Mandatory rules are essential for protecting corporate creditors, as self-help mechanisms are not available to all types of creditors, especially those with less bargaining power. Statutory provisions for bargaining between companies and creditors are efficient and less costly. Mechanisms include mandatory disclosure, capital-related requirements, shareholder claims subordination, rules governing opportunism, and reducing opportunism by company controllers. Legal rules provide incentives and remedies, including fraudulent conveyance law, lender liability, legal capital rules, and fiduciary duties to creditors. For more, see; Pau L. Davies, Introduction to Company Law, 2nd edition, Oxford University Press, USA, 2010, P.71.

[62] Tarell, *supra note* no. 56.

[63] Id.

mechanism are provided in some prior publications and won't be repeated here.[64]

The second major category of mechanism for protecting company creditors is a contractual or self-help mechanism. This mechanism views the firm as a nexus of contracts, with creditors entering numerous contracts voluntarily to maximize their benefits.[65]Corporate creditors seek protection through the terms of the contract with the debtor, making it a primary matter of contract rather than company law.[66] Creditor self-help as an alternative to creditor protection by mandatory rules is not available per se to "pure" tort creditors but only to contractual creditors.[67]Self-help mechanisms include third-party credit insurance, debt covenants, collateral, personal guarantees, and interest rates.[68]

4. A Case for Parent Company's Potential Liability for the Debts of Its Subsidiaries under Ethiopian Corporate Group Laws

[64] Tigist, *supra note* no. 7.

[65] Accordingly, corporate creditors, as a third party who contracts voluntarily, seek to gain adequate protection through the terms of the contract with the debtor. As a result, the issue of corporate creditor protection is considered a primary matter of contract rather than company law. The creditor self-help mechanism, as it can be understood from its name, isn't available for involuntary creditors as they have no prior contractual relationship with the company before they become a creditor. Creditor self-help as an alternative to creditor protection by mandatory rules is not available per se to "pure" tort creditors but only to contractual creditors.

[66] Tarell, *supra note* no. 53, p. 47–48.

[67] Peter O. Mülbert, A Synthetic View of Different Concepts of Creditor Protection—Or: A High-Level Framework for Corporate Creditor Protection, Law Working Paper No. 60/2006 (February 2006), P. 20: available at https://www.ecgi.global/sites/default/files/working_papers/documents/SSRN-id883625.pdf (accessed July 3, 2023).

[68]Id, Covenant is contracts between a corporate creditor and debtor determining loan terms and conditions. Obtaining collateral is the most effective self-help mechanism, as it avoids ex-post opportunism and grants a property right. Collateral also self-enforces, allowing the creditor to enforce security upon debtor defaults.

This section presents a critical analysis of the RCC's provisions, other relevant Ethiopian laws, and pertinent national laws of other countries in order to make the case for a parent company's potential liability for the debts of its subsidiaries in the context of the subsidiary company's creditors' protection.

4.1. A Parent Company’s Control Right, the Manner of Its Exercise and Its Implication on Subsidiary Company’s Creditors’ Protection

A parent company has 'instruction rights' over a subsidiary company, which is obliged to obey the instructions issued by the parent. Art. 556/2 of the RCC states that the organs of management of a subsidiary must comply with the instructions issued by the parent, subject to certain conditions and exceptions. However, the provision does not specify the nature of the instructions or the standard of care expected of the person furnishing the instructions on behalf of a controlling parent company. This raises the question of whether a controlled company has the right to scrutinize if the instructions advance the interests of the parent company, a subsidiary company, or the group in general. In Germany, a controlling undertaking holding shares in a dependent company has an enhanced duty of good faith in all its relationships with the subsidiary company and its shareholders.[69] If the controlling company violates its duties, every minority shareholder in the dependent company has an action for discontinuance against both the controlling and dependent companies.[70]

The RCC's position on instructions and the standard of care expected from a parent company's legal representatives is unclear. However, many foreign jurisdictions have clear standards for parent company behavior when giving instructions to a subsidiary. For example, in Germany, legal representatives

[69] Andenas and Wooldrigde, *supra note* no. 41, p. 482.
[70] Id.

must be careful and conscientious when giving instructions, and if they breach these duties, they are jointly and severally liable for damages.[71] The law also mandates parent company management to not give instructions detrimental to the interests of a subsidiary company, and vice versa.[72] Violation of this rule results in liability for damages and creditors of a subsidiary company who fail to satisfy their claims from the subsidiary enterprise's assets.[73] It is desirable to have clear legal provisions on this aspect under our RCC as well

The controlling company's instructions must be honored by the management organs of the controlled company, as per Art. 556/3 of the RCC. Nonetheless, not every management body of a subsidiary is bound by instructions from the parent company. Art. 556/3 states that directors and managers not appointed by the parent company but due to provisions in the memorandum of association, shareholders' agreement, or any law or regulation are not bound by the parent company's instructions. The law also states that a subsidiary company's board of directors or management acting against its interests is not considered a breach of fiduciary duties.[74] However, Art. 563/2 allows the board of directors or management body of a wholly owned subsidiary not to breach its fiduciary duty even if they make decisions contrary to the subsidiary's interests or conduct detrimental to it without an assumption of expected gains.

The RCC permits subsidiary company management to refuse patent company instructions if they do not advance the group's interests, do not assume

[71] Paragraph 309 of German Stock Corporations Act 1965.

[72] Id.

[73] Italian law recognizes joint liability for damages suffered by wrongful acts on a subsidiary, as per the Civil Code. Those who profit from such acts are also liable. However, members and creditors can only take action against the parent company if they cannot obtain satisfaction from the subsidiary. See Article 2497(2) of the Italian Civil Code.

[74] RCC, art. 563/1.

damages will be balanced by expected gains, and could potentially jeopardize the subsidiary's existence.[75] If they do, they will be jointly liable with the parent company towards creditors of the subsidiary, who cannot meet their claims solely with the subsidiary's assets. The RCC does not provide remedies for interested parties, including creditors affected by subsidiary companies acting on a parent company's prejudicial instructions. Although the RCC grants a parent company significant power to manage and interfere in subsidiary affairs, it is unclear if the parent is liable to subsidiary creditors.[76] However, a parent company may be liable for damages to subsidiary companies and their creditors who fail to meet their claims with the subsidiary's assets. The RCC does not prescribe a standard of conduct for parent companies, potentially allowing them to abuse control rights and negatively impact subsidiary shareholders and creditors.

It also important to mention that, a parent company can potentially abuse control over its subsidiary through majority shareholding and acting as a director. Under the RCC, an organization or institution can be appointed a director and appoint a permanent representative for its term.[77] The representative is subject to the same obligations, including civil and criminal liability, as a director in their own name, without prejudice to the joint liability of the legal entity they represent. Under the RCC, directors shall be responsible for exercising duties imposed on them by law, memorandum of association, and resolutions of general meetings of shareholders.[78] Thus, where a parent company acts as a director of a subsidiary company, it will be subject to duties expected of a director, such as a duty of loyalty[79] , a duty to

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[75] Id.

[76] Mesfin, *supra* note no. 10, p. 210.

[77] RCC, Art. 296/4/5.

[78] Id, art-315.

[79] Id, art-316.

exercise independent judgment[80] , a duty of care and diligence[81], a duty of strict good faith[82] , and a duty to avoid conflict of interest.[83] As a director of the company, the parent company has a duty and liability prescribed for directors in general. Based on that, the veil of limited liability of the parent company can be pierced, and the creditor of the subsidiary company can proceed against the parent company, which acts as the director of their debtor, if a parent fails to preserve the assets of the subsidiary company.

The RCC states that directors shall be liable for damage caused to creditors where the company continues its business after the time when the directors knew or ought to have concluded that there was no reasonable prospect of the company being able to pay its creditors.[84] Directors who fail to preserve intact the company's assets shall be liable to the company's creditors to the extent of the reduction in the company’s assets they caused where the company’s assets are not sufficient to pay creditors.[85] Even the company`s decision not to institute proceedings against the directors shall not affect the creditor`s rights to sue such directors.[86] In addition to a parent company acting as a director of a subsidiary, it can also potentially abuse its control over a subsidiary while acting as a majority shareholder of a subsidiary company. Therefore, a parent company that engages in an abuse of its control over the subsidiary company, either as the latter’s director or a majority shareholder, will be potentially liable to creditors of the subsidiary company if they fail to meet their claims only with the assets of the debtor subsidiary company.

[80] Id, art-317.
[81] Id, art-318.
[82] The Civil Code, Art. 2209.
[83] RCC, Art. 320.
[84] Id., Art-329/1.
[85] Id., Art-329/2.
[86] Id., Art-329/3.

Another important aspect in the discourse of control and/or instruction by a parent is the issue of the requirement of publicity of control to third parties. The RCC requires a non-wholly-owned subsidiary to indicate in the Commercial Register if its management is directed by the parent company.[87] A wholly-owned subsidiary is presumed to be subject to the parent company's instructions and does not need to disclose its ownership.[88] The question is whether the subsidiary needs to disclose being controlled by another company in transactions and correspondences, and if this disclosure affects the parent company's potential liability towards the subsidiary's creditors. This aspect of publicity is recognized in some national jurisdictions. For instance, Article 2497 of the Italian Civil Code mandates a subsidiary company to indicate its subjection to another company's direction and coordination in transactions and correspondence.[89] This subjection must also be indicated in a special section of the Register of Enterprises, with the parent company exercising control also appearing in this section.[90] Directors who fail to comply or maintain a record indicating the subjection still exists may be responsible for damage caused to members or third parties.[91] However, under the RCC, there is no requirement for a subsidiary company to disclose control to the management of a subsidiary company, and failure to do so does not result in misrepresentation.[92] Creditors of a subsidiary company who fail to meet their claims can proceed to a controlling parent company if they can prove abuse and mismanagement of the debtor subsidiary by the parent company.

[87] Id., Art-556/4.
[88] Id., Art. 556/5.
[89] Art. 2497 of the Italian Civil Code, *Codice Civile*, Approved by Royal Decree no 262/1942 and amended from time to time.
[90] Id.
[91] Id.
[92] RCC, Art. 554, The provision mandates parent company management to notify subsidiary management of control changes, and unless foreign, the subsidiary must inform parent company of its shares and voting rights, unless recognized by the relevant country's law.

4.2. A Parent Company Exploiting Corporate Group Entrepreneurial Opportunities

Exploitation is the unfair use of another person's vulnerability for one's own benefit, which can be transactional or structural.[93] It can be a discrete transaction, such as a sweatshop or pharmaceutical research firm, or a structural property of institutions where the rules unfairly benefit one group to the detriment of another.[94] One of the key rules incorporated under the section of the RCC governing corporate groups is the rule that prohibits a parent company from exploiting corporate opportunities within a group.[95] Yet, it is unclear what constitutes a corporate opportunity. In principle, a parent company is prohibited from exploiting corporate opportunities within a group, whether directly or indirectly through another subsidiary. Yet, the RCC provides exceptional grounds and preconditions under which a parent company is allowed to exploit a group opportunity. The first situation is where a parent company has secured the approval of directors of the subsidiary that have not been appointed by it. However, where all directors of a subsidiary are appointees of a parent company, it does not need to secure their approval. Instead, a parent company has to secure the approval of the non-controlling shareholders of the subsidiary. Although the provisions require the approval of the non-controlling shareholders of the subsidiary,

[93] Stanford Encyclopedia of Philosophy, Exploitation (December 20, 2001; Substantive Revision, Monday, October 3, 202) https://plato.stanford.edu/entries/exploitation/ (Accessed March-22-2024).

[94] Id.

[95] RCC, Art. 560, states that "A parent company, whether registered in Ethiopia or abroad, must not itself or through another subsidiary exploit a corporate opportunity of a subsidiary *unless it has received the approval of directors of the subsidiary that have not been appointed by it, and if there are none, of the non-controlling shareholders of the subsidiary*. The prohibition imposed on a parent company under Sub-Article (1) of this Article shall not apply to a wholly owned subsidiary" (Emphasis Added).

which presumably has the objective of protecting minority shareholders in a subsidiary company, the law does not prescribe the level of capital holding expected of these 'non-controlling shareholders of the subsidiary' and potentially creates ambiguity on the implementation of this rule.

The RCC follows a different approach where a subsidiary happens to be 'a wholly owned' one, in which a parent company is allowed to exploit a corporate opportunity of a group without preconditions.[96] From the above analysis of provisions of the RCC, we can argue that there are instances where a parent company exploits corporate opportunities within a group in violation of or without following the preconditions set out under Art. 560 and thereby poses damages to a subsidiary company. The damage sustained by a subsidiary company because of unlawful exploitation of group opportunities may reduce the chances for creditors of the latter to collect their claims from the subsidiary. Thus, a parent company that has rendered a subsidiary unable to meet the claims of its creditors due to the exploitation of opportunities within a group will potentially be pursued by the creditors of the subsidiary company.

4.3. Wrongful Trading, Subsidiary Insolvency and Creditors' Protection

Sometimes a subsidiary company's business viability may be significantly weakened, and it may find itself on the verge of dissolution or bankruptcy. The protection of creditors during the time the debtor company is still in operation but is on the verge of going bankrupt is the fundamental idea behind wrongful trade.[97] During this time, divergent incentives can be observed. In

[96] Id., art-560 (2) (3).

[97] Zoltán Fabók, Wrongful Trading in England and Hungary: A Comparative Study, *A Comparative Study' in Dr Jennifer L. L. Gant (ed), Harmonisation of European Insolvency*

the best interests of the business, the director could wish to negotiate the company's way out of the sticky situation, but in order to do so, he will probably need more time, more credit, and new obligations.[98] The unsecured creditors can be worried that the debtor's assets, which are the only security that can pay for their claims, are disappearing and that this will put them in a worse situation than if official bankruptcy procedures had been initiated sooner.[99] In principle, a director has an obligation to act in the company's and its shareholders' best interests. Nonetheless, a director's primary responsibility in the event of insolvency is to safeguard the interests of the company's creditors. Insolvency shifts a director's responsibility from promoting a company's success to acting in the best interests of creditors.[100] Directors may consider ceasing trading, but this may not always be in the best interest of creditors.

A key principle of corporate law holds that, as a company is an independent legal entity, it bears exclusive responsibility for its debts. This notion is not absolute, nonetheless, as company laws and court rulings have proven that the company's independent legal personality may be bypassed for the purpose of holding directors or shareholders liable for the debts the company incurs.[101] Wrongful trading is one of the grounds whereby directors might be held accountable for the company's debts. On this issue, the corporate group laws in Europe make two proposals concerning the liability of the parent company in the event that its subsidiary is unable to escape winding up by means of its

Law (2017), p. 85, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2896290 (Accessed March 3, 2024).

[98] Id.

[99] Id.

[100] Since Green, What is Wrongful Trading? (08/08/2023); https://www.crowe.com/uk/insights/what-is-wrongful-trading (Accessed April-14-2024).

[101] Nzafashwanayo, Dieudonne, Wrongful Trading: The Liability of Directors for the Obligations of the Company Under Rwandan Law (September 2, 2016), PP. 3–4. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833820 (Accessed April-14-2024)

own resources.[102] The first proposal observed under the laws of English, French, and Belgium provides that the parent company would be obliged to carry out a fundamental restructuring or initiate the winding up procedure.[103] A failure of this rule by the parent company renders it liable to the subsidiary company in liquidation for the losses caused to all creditors by the said acts.[104] This consequence is based on the presumed knowledge of the parent about the subsidiary company's arrival at a crisis point.[105]

In Ethiopia, in the context of a corporate group, the RCC obliges a parent company to take necessary measures to save the subsidiary company on the verge of bankruptcy from failure. It states;

1. Whenever a subsidiary company, which has been managed according to instructions issued by its parent even in the interest of the group, has no reasonable prospect, by means of its own resources, of avoiding dissolution or winding-up, the parent company *shall without delay effect a fundamental restructuring of the subsidiary or initiate its winding-up procedure*.
2. If the parent company acts in contravention of Sub- Article (1) of this Article, it shall be held *liable for any unpaid debts of the subsidiary incurred after the said crisis point*.
3. If the parent company has managed the subsidiary to the detriment of the subsidiary and in violation of the interest of the group, it *shall be held liable for any unpaid debts of the subsidiary which are the consequences of the harmful instructions*.

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[102] Andenas and Wooldrigde, *supra note* no. 41, p. 484.
[103] Ibid.
[104] Id.
[105] Id.., Also, according to Article 2497(2) of the Italian Civil Code, persons who have taken part in wrongful acts that have damaged the subsidiary incur joint liability with the parent company for damages suffered by it. Persons who consciously benefit from such acts are also liable within the limits of the advantages obtained by them.

4. The right to claim compensation provided for in Sub- Articles (2) and (3) of this Article can be invoked *only by the liquidator or trustee of the subsidiary. The liquidator or trustee, as the case may be, is obliged to exercise such claim if creditors holding not less than 10 % of the debts of the subsidiary request that.*[106] (Emphasis Added)

Pursuant to Art-564/1 of the RCC, a parent company that exercises control over another subsidiary company has an obligation to prevent a subsidiary company from going to dissolution by effecting *a fundamental restructuring* or, if the chance of restructuring is not feasible, to initiate a timely winding-up procedure. The failure by a parent company to do so makes it liable for any 'unpaid debts of the subsidiary, which are the consequences of the harmful instructions' under Art-564/2. The liability of a parent company is restricted to the debts incurred by a subsidiary company after the crisis point. Parent company acting quickly means no liability, even if its intervention has affected the subsidiary's creditors. The fact that instructions issued by its parent had the potential to advance the interests of the group does not seem to make a parent free from the obligations imposed, so long as a subsidiary has no reasonable prospect, by means of its own resources, of avoiding dissolution or winding-up.[107]

Art. 564/3 of the RCC provides two cumulative requirements to hold a parent company liable for the debts of its subsidiary: managing the subsidiary to the detriment of the subsidiary and in violation of the interests of the group. Concerning the extent of the parent company's liability, the provision states that it shall be held liable for any unpaid debts of the subsidiary, which are the consequences of the harmful instructions. Concerning the nature of a parent company's liability, Art. 564/4 provides that it is in the form of compensation

[106]RCC, Art. 564.
[107] Id., art-564/2.

that, in principle, can only be invoked by the liquidator or trustee of a subsidiary company at their option. Nonetheless, the liquidator or trustee of a subsidiary company has a legal obligation to claim compensation from a parent when creditors hold not less than 10% of the debt.

A few observations are in order concerning the liability of a parent company under Art. 546 of the RCC. Firstly, it is important to note that the RCC does not impose a mandatory rescue obligation on the parent, which could affect creditors and minority shareholders.[108] Secondly, the liability of a parent company does not depend on whether the assets of a subsidiary company are sufficient or otherwise to meet the claims of its creditors. Thirdly, creditors are not authorized to file a direct claim against the responsible parent company. Finally, a parent company's liability is in the form of compensation, and its amount is not unlimited.

Art. 564 provides two modes of compensation subjected to different requirements, both of which require proof of the fact that a subsidiary company failed to pay its debts as expected of it as a result of harmful instructions by a parent company. The compensation scheme under Art-564/2 seems to be the responsibility of a parent company to make a subsidiary incur additional debts. The key differences between Art-564/2 and Art-546/3 are that the amount of compensation for the former is equivalent to 'any unpaid debts of a subsidiary company that are the consequences of the parent company's harmful instructions *incurred after the said crisis point* '; whereas the latter does not make reference to the time when the debts are incurred by the subsidiary. Instead, Art. 564/3 makes a parent company liable for being a reason for the subsidiary's inability to pay debts, rendering the amount of compensation presumably unlimited.

[108] Id., Arts-560, and 564.

In effect, art. 564/3 of the RCC amounts to piercing a corporate veil.[109] Yet the Code fails to clarify whether instructions by a parent company and obedience by its subsidiary to the instructions can raise a ground for treatment as ‘alter ego’ and thereby result in piercing of a corporate veil or 'single business entity’ or ‘agency’ reason that renders a parent company liable for the debts of the subsidiary company.[110] The clarification of this approach helps courts of law enforce the mandatory shareholders and/or directors in single companies to be applied in corporate groups.[111] In general, there is no explicit legal provision in Ethiopia governing how to handle a subsidiary's insolvency. This approach might make the subsidiary even more insolvent, which would encourage risk-averse people to create fictitious companies as a way to protect themselves from unsecured creditors. Article 295 can, however, be invoked to help close these legal gaps, particularly in cases where a parent shareholder commits crimes that jeopardize the interests of the subsidiary or make it difficult to distinguish between the subsidiary and itself.[112] One may also argue for the possible application of RCC Art. 850/1, which establishes the liability of shareholders (in this case, a parent company acting as a shareholder of a subsidiary company) to creditors of a subsidiary in the event that a parent commits fraud or issues instructions that cause a subsidiary to stop making payments to its creditors.[113] These two suggestions can assist Ethiopia in harmonizing with other nations concerning the piercing of a corporate veil.

[109] Mesfin, *supra* note no. 10, p. 226.
[110] Id.
[111]Id.
[112] Id.
[113] This rule seems to endorse the general company law notion that limits shareholders' liability and extends their liability to third parties only in exceptional cases. It is placed under the section of the RCC that governs bankruptcy.

4.4. Violation of the Prohibition of Share Cross Holdings and Its Implication on Creditors' Protection

It is to be noted that maintaining a company's capital helps a company properly exploit its capital for its legitimate purpose. When implemented effectively, it restrains the improper return of capital to shareholders through capital reduction, capital raising, company distribution, and share cross-holding.[114] Share cross-holding between two or more companies occurs when one company subscribes shares in another company and, in return, that other company also acquires shares of its member company.[115] Share cross-holding, either between two companies or more than two companies, has a high negative impact on capital maintenance.[116] In the context of group companies, the RCC states that 'a subsidiary may not hold any shares directly or indirectly in the parent company.[117] This provision puts a complete ban on share cross-holdings between a parent company and its subsidiary.[118] Yet, Art. 555 of the RCC does not address cross-holding among more than two companies, which potentially amounts to allowing multiple parent subsidiaries to cross-hold each other's capital without any limit.[119] The aim of the law in prohibiting a share cross holding between a parent company and its

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[114] Yomilata Mando, Capital Maintenance in Ethiopian Non-financial Share Companies: The Law and the Reality on the Ground, LLM Thesis, AAU (June 2020), p. 51 http://213.55.95.56/handle/123456789/22280 (accessed July 21, 2023).

[115] Corporate Finance Institute, Cross Holding (2015), Available at; https://corporatefinanceinstitute.com/resources/management/cross-holding/#:~:text=What%20is%20Cross%20Holding%3F,holding%20of%20the%20first%20company . (Accessed September 11, 2023).

[116] Id.

[117] RCC, art. 555/1

[118] Of course, the law makes a distinction between companies having a parent-subsidiary relationship and those that do not. The RCC does not provide a complete ban on cross-shareholdings for companies not constituting a group; instead, it sets conditions and a limitation threshold. In this case, where a second company holds 5% or more of the capital of the first company, the first company may not hold shares in the second company.

[119] Yomilata, *supra* note 114, p-34.

subsidiaries is to maintain the capital of both companies and thereby protect the interests of their creditors. So, a parent company through its control right compels a cross shareholdings with its controlled company in violation of the provisions of the RCC; one can argue for the liability of a parent company towards creditors of its subsidiary.

Concluding Remarks

Large firms today are often organized as corporate groups with numerous subsidiaries, each having a separate legal personality. However, this separation of legal existence is not matched by the economic independence of the units, as one company may dominate another through majority ownership, centralized or common management, and an enterprise agreement. This dominating influence can lead to the group company serving the interests of the controlling company, impairing the assets of member companies, providing inadequate consideration, and extending credit at a lower rate. This situation threatens the interests of the units, their minority shareholders, and their creditors. Special regulation of affiliate companies is necessary to protect these interests. Creditor protection is usually provided through statutory legal provisions, insolvency laws, or self-help mechanisms. In the Ethiopian legal system, affiliate companies are emerging as an organizational form in both the financial and non-financial sectors.

The study critically analyzed the legal frameworks on the protection of a subsidiary company's creditors within corporate groups under Ethiopian laws, focusing on the questions of whether a creditor of a subsidiary company should pursue the assets of a corporate parent to satisfy its claim, how parent companies should be treated when a subsidiary lacks sufficient assets to satisfy its creditors, and the mechanisms adopted under the RCC for the protection of creditors.

The findings of the work reveal that; in Ethiopia, the parent company has the right to instruct a subsidiary, shift assets, and exploit its corporate opportunity, which can affect the subsidiary and even expose it to insolvency. Liability arising from these activities is in principle, limited to the assets of the individual subsidiary. The Code does not impose a mandatory rescue obligation on the parent, which could affect creditors and minority shareholders. The principle of the corporate veil is not applicable unless the subsidiary company is managed according to instructions issued by its parent. However, if the parent company acts without delay in the subsidiary's restructuring or liquidation, it is not liable to creditors.

Concerning the potential legal consequences of parent firms misusing their authority to assume the role of director or majority shareholder of a subsidiary, one must examine the RCC rules not specifically designed for corporate group setup. The section of the RCC governing corporate groups lacks adequate legal provisions and cross-references to other Code provisions, potentially exposing them to speculation and incorrect legal provisions.

Also, the RCC's approach to instructions and the standard of care expected from a parent company's legal representative are unclear. Many foreign jurisdictions have specific standards for parent company representatives when giving instructions to a subsidiary. For example, in Germany, legal representatives must be careful and conscientious, and if they breach their duties, they are jointly and severally liable for damages. In Italy, individuals involved in wrongful acts that damage a subsidiary incur joint liability with the parent company. However, members and creditors can only take action against the parent company if they cannot obtain satisfaction from the subsidiary. The RCC does not address the issue of publicity of control by a subsidiary company that is under the supervision of another company. However, some jurisdictions recognize this aspect, such as the Italian Civil Code, which requires a subsidiary corporation to declare its control in

transactions and correspondences. Directors of controlled companies are liable for any harm caused to shareholders or third parties.

Based on the above findings, the writers forward the following recommendations:.

1. The section of our RCC that governs corporate groups in general fails either to incorporate adequate legal provisions or make cross-references to other general provisions of the Code. This is not a good legislative drafting style, as it exposes us to speculations and/or incorrect legal provisions.

2. The approach reflected in the RCC concerning the nature of the instructions and what degree or standard of care is expected of the person furnishing the instructions on behalf of a parent company is unclear. Having clear legal provisions on the aspects addressed here is desirable under the RCC as well. In order to help creditors of a subsidiary company take calculated risks while doing business with a firm that is supervised by another company, such an approach needs to be recognized under our RCC.