PREEMPTIVE RIGHTS AND ANTI-DILUTION RULES: THE LESSONS FROM US TO ETHIOPIA

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ABSTRACT

In the era of globalization, investors' confidence on the market and corporation incentivize the infusion of tremendous amount of capital which aid in the growth and development of the corporation and the country at large. To create that confidence formulation of effective legal and regulatory measures that can accommodate and forecast the current and future needs of investors is vital. Among the means for creating such trust are preemptive rights and anti-dilution rules. These laws protect the interest of existing shareholders and investors from the dilution of their percentage and economic value of their ownership stakes. These protections are being used in the US on contractual basis which the investors and shareholders can opt-in in the carter of incorporation. As opposed to the US, in Ethiopia, preemptive rights are the only mandatory existing shareholders' protection that is recognized despite the existence of convertible debentures. Hence it is, therefore, highlighted in this thesis that Ethiopia should make use of these protections just like the US system. However, such protections shall be afforded in mandatory form than opt-in rule.

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INDEX AND ABBREVIATION

DGCL	Delaware General Corporate Law
MBCA	Model Business Corporations Act
Cal.	Californian
Corp.	Corporation
N.Y.	New York
GAAP	General Accepted Accounting Principle
SEC	Securities and Exchange Commission
Com. Code	The 1960 Commercial Code of Ethiopia
US	United States of America
Vol.	Volume
Del. Ch.	Delaware Court of Chancery
DC	Delaware Code

INTRODUCTION

Equity financing in secondary markets is one of the means for a company to take advantage of economies of scale and keep pace with the growing market demands locally and abroad. [1] Though the motives behind this are plausible, the diluting effect the issuance of new shares have on the existing shareholders percentage of ownership and the economic value of their shares in cases where shares are issued below the per value have become a cause for concern.[2]To curb these problems and protect the interest of existing shareholders, a solution provided by different jurisdictions is the adoption of pre-emptive rights[3] and anti-dilution rules.[4]

Pre-emptive rights mandate corporations to offer existing shareholders the right to purchase new shares prior to being offered to the public proportionate to their shareholding.[5] It is only after existing shareholders fail to exercise their rights can shares be offered to the public. [6]Anti-dilution provisions, on the other hand, "are designed to protect holders of convertible securities against dilution from a large variety of corporate events, including, among others, stock dividends and splits, cheap issuance of additional common stock, and distribution of cash or property."[7] This rule accords the holder of the conversion privilege a security that their rights will not be affected by the activities of the corporation.[8]

[1]Araya Debesay & Tadewos Haregework, *Towards the Development of Capital Market in Ethiopia*, THE ETHIOPIAN ECONOMY: PROBLEMS AND PROSPECTS OF PRIVATE SECTOR DEVELOPMENT (PROCEEDINGS OF THE THIRD ANNUAL CONFERENCE ON THE ETHIOPIAN ECONOMY) 228 (1994).
[2] Marham & Hazen, Corporate Finance (Thomson & Wed, 2003), p.285.
[3] Marco Ventoruzzo, *Issuing New Shares and Preemptive Rights: A Comparative Analysis*, 12 RICH. J. GLOBAL L. & BUS. 517, 517 (2012).
[4] Stanley A. Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 THE UNIVERSITY OF CHICAGO LAW REVIEW 1, 1 (1965).
[5] Ventoruzzo, Supra note 3.
[6] Kaplan, *supra* note 4, at 1.
[7] Tao Tim LIANG, *The Enforceability Of Anti-Dilution Provisions in Private Placement Transactions in China*, TSINGHUA CHINA LAW REVIEW 46 (2013).
[8] George S. Hills, *Convertible Securities. Legal Aspects and Draftsmanship*, 19 CALIFORNIA LAW REVIEW 1, 2 (1930).

The 1960 Ethiopian Commercial Code belongs to the civil law legal system. [9]This code which is inspired by the French Commercial Code mandates pre-emptive rights and allows relinquishment of such rights in specific circumstances. [10] The law gives no place to contracts in the according of this right by clearly prohibiting such provisions in any other document.[11] When we come to anti-dilution rules, there is nowhere in the code that mentions this rights despite the fact that conversion rights to debentures are provided.[12] The fact that the law only allows the issuance of shares with identical features and the practice of mostly issuing common shares for abhorring accounting problems is an additional factor that is forestalling the creation of this rule.[13]Furthermore, the lack of stock markets in the country is exasperating this problem. [14]

The jurisdiction to draw lessons from is U.S. which belonging to legal family the Common law legal system.[15] This system which is known for its no default rule for preemptive rights, confers unrestrained contractual freedom within the corporation allowing the parties to opt-in for such rights if they choose to make use of them in the charter of incorporation of the company.[16] Irrespective of whether they have opted for this option or not, as a means to protect the shareholders interest the law places a fiduciary duty on board of directors which is aided by an ex-post legal remedy, special corporate forms and other regulatory bodies. [17] This regulatory bodies are provided as a means of disciplining the corporation and its directors in the handing of

[9] Fekadu Petros Gebremeskel, *Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications*, 4 MIZAN LAW REVIEW 1, 2 (2010).
[10] COMMERCIAL CODE PROCLAMATION NO 168/1960, *THE COMMERCIAL CODE PROCLAMATION OF 1960, ARTICLE 345, at 72 (ethiopia).*
[11] Ibid.
[12] Fekadu Petros Gebremeskel, Ethiopian Company Law, Addis Ababa University, Law School, (2012) at 86.
[13] Id.
[14] Ayele, A.G. (2013), *Revisiting the Ethiopian Bank Corporate Governance System: Glimpse of the Operation of Private Banks*, 2013(1) Law, Social Justice & Global Development Journal (LGD).
[15] Ventoruzzo, *supra* note 3, at 519.
[16] Ibid.
[17] Reinier Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd Ed, 86 (2009)

the business and shareholders' interest.[18] Similarly, the system provides rules governing anti-dilution by providing different approaches that can protect the interest of investors which is also the subject of contractual agreement between the corporation and the investor which have become an integral part of the package of privileges investors demand and founders offer.[19]

To attract investors and accommodate their diversified needs, opening our doors to more complex types of securities is vital.[20] The role of regulatory mechanisms that can aid in the creation of trust in the system while housing the interest of both ends of the spectrum i.e. investors and the company is undeniable.[21] Coupling both features will have a great impact in the transformation of the country's infant economy to the next level. What better time to suggest such improvements than today when Ethiopia's Commercial Code is undergoing amendments.[22]

1) Roadmap to the Thesis

This thesis is aimed at bringing the concept of anti-dilution rules and widely exploring the concept of preemptive rights as regulatory mechanism for the protection of shareholder so as facilitate and encourage the issuance of more complex securities in Ethiopia. Moreover, it is also aimed at showcasing as an alternative means to protect shareholders in addition to the existing laws in the country. This is done through focusing on the U.S. legal system as a primary focus of jurisdiction to draw a lesson from. To make this effective the thesis will be divided into different Four Chapters that will discuss in a great detail issues relating to the subject matter.

[18] Ibid.
[19] Ibid.
[20] Gebremeskel, *supra* note 12.
[21] Ibid.
[22] Asress Gikay,The Role of workouts under US and the Ethiopian Bankruptcy Law: A Comparative Analysis, Central European University(2011), at 4.

In this thesis, we will start in Chapter One by focusing Increasing of Capital through Stock offering. Under it we will focus on requirements to raise capital, corporate securities and vested rights.

The Second Chapter will be devoted to discussing, the problems associated with stock subscription and the panacea provided into two parts. Part I deals with issues of dilution relating to stock subscriptions and watering of stocks in great detail so as to have firsthand information as to where the problem lies. Part II devoted to panacea provided which are Preemptive rights and Anti-dilution rules.

Third Chapter is will examine the applicability of preemptive rights and anti-dilution rules in the US and the viability of adopting this rules in Ethiopia. Part I is allocated to discussion of the U.S. system. Part II- to the Ethiopian Legal system. This is analysis is done through statues, contracts and economic indicators for both systems.

Final Chapter will come forward with some conclusions and recommendations.

CHAPTER ONE

INCREASING COMPANY'S CAPITAL THROUGH SUBSEQUENT STOCK OFFERING

1.1. Requirements for the issuance of new shares

Corporation[23] when choosing to increase its capital via stock offering in a secondary market, two issues come to play. These are the requirements set by all jurisdictions for the issuance of new shares and the need to balance the interest of existing shareholder whose interest will be affected by such issuance.[24] In this chapter discussion as to the requirements of approval and mode of payments will be dealt with.[25]In the upcoming chapter the need and the means to balance the existing shareholders in the issuance of new shares will focused on.

1.1.1. Approval of the issuance of new shares

A corporation is governed by string of laws that monitor the everyday activities of the corporation.[26] Whenever a company chooses to perform any type of act that determines the fate of the corporation, one monitoring mechanism is approval requirement.[27] Typically, the issuance of new shares triggers the mandatory approval requirements of either board of directors or shareholders in a company in most jurisdictions.[28]The demarcating line in the requirement of

[23] This thesis uses the terms "company" and "corporation" indistinguishably. Corporation is a US term, company a German one – and they do not necessarily match fully. Though these terms may not always mean the same thing, the focus of our thesis and the term used in this thesis is to infer to stock corporations/companies limited by shares which possess the five main characteristics of corporate law that is legal personality, limited liability, transferable shares, centralized management under the board structure and investors ownership. CAHN & DONALD, *supra* note 24 at 195

[24] ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW: TEXT AND CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 259 (Cambridge University Press 2010)at 195

[25] Ibid.

[26] Gebremeskel, Supra note 12.

[27] Ibid.

[28] CAHN & DONALD, *supra* note 24 at 195

approval is the "charter of incorporation"[29] of each company that mandates in its provisions a specifically inclusion of the (authorized) shares, the number and classes of shares, their par value (if any) and the powers, rights, qualifications and restrictions of these shares.[30]

On the basis of what has been provided in the charter, directors in all jurisdictions exercise their bestowed powers in the issuance of new shares in diverging ways. To take the example of US Delaware, there is a set limit of authorized share in the charter of incorporation which delineates the power of the board to issue and which shareholders cannot intervene in such rights. [31] Whenever the management proposes to issue new shares within the limit set, the board will approve such share issuance for adequate consideration.[32] If what is proposed is above the stated limit shareholders' approval is required because it requires the amendment of the charter of incorporation. [33] This procedural requirement begs for the question why follow all this procedures?

Corporations typically are business that entertains a large amount of capital which is collected from its shareholders who become "owners" of the company's shares proportionate to their holdings.[34] It is not always the case that the shareholders will participate in the management of the company.[35] Even if they do, there is no guaranty that they will act in the best interest of the

[29] "Charter" of a corporation(in U.S.) which has various terms among jurisdictions such as Memorandum and Article of Association (Ethiopia) is a special sort of contractual devise that allows flexibility, constitutional commitments and publicity. It establishes the basic governance structures; they allow entrenchment of terms, typically through a special amendment process; and they public. Unlike ordinary contracts can be amended with less unanimous approval by the parties to the charter and must be filed and are generally available to anyone who asks. KRAAKMAN , *supra* note 17 , at 186

[30] Ibid.

[31] MBCA§6.21(b) and DGCL §161.

[32] Ibid.

[33] KRAAKMAN , *supra* note 17 , at 186

[34] Don Berger, *Shareholder Rights under the German Stock Corporation Law of 1965*, 38 FORDHAM L. REV. 687, 1 (1969).

[35] Gebremeskel, Supra note 12 at 2.

corporation. [36]Consequently to resolve this "agency problem"[37], the demarcation of power which centralized management is not to surpass is set forth irrespective of the structure of ownership these companies indulge in: dispersed[38] or concentrated[39].[40]

The limit set forth by almost all jurisdictions is on the basis of whether the changes proposed by the board are fundamental change or not.[41] Fundamental changes are determined by two basic features which relate to "the size of the corporate action and the risk of "self-interested decision making" by the board."[42] If the decision by the board is something that could drastically affect the interest of "firm's participants"[43] either by its potential gravity and /or likelihood of creating conflict of interest, such changes are determined to be fundamental and require approval.[44]

Among the list of fundamental changes in the company that is recognized by all jurisdictions are share issuance; charter amendment and merger are part of the list and are made the subject of scrutiny.[45] The rationale behind subjecting the issuance of new shares to special regulation is due

[36] Ibid.

[37] Agency problems arise in business firms which involves conflict between the firm's owners and its hired mangers (where there exists a principal and agent relationship), conflict between majority and minority shareholders and conflict between the firm itself, including particular owners and the other parties with whom the firm contracts, such as creditors employees and customers. KRAAKMAN , *supra* note 17, at 36.

[38] Dispersed Ownership denotes the separation between ownership and control. It is characterized by "strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism" on management.1 due to is where the control and ownership in a company. Gebremeskel, supra note 9 at 7.

[39] The concentrated ownership model is essentially characterized by the existence of controlling block holders in the company. Often, countries with this paradigm of corporate governance tend to have weak securities markets, and low disclosure and market transparency standards. Gebremeskel, supra note 9 at 11.

[40] CAHN & DONALD, *supra* note 24 at 186

[41] Ibid.

[42] KRAAKMAN , *supra* note 17, at 36.

[43] Firm's participants are shareholder, stockholders, creditors and the like. KRAAKMAN , *supra* note 17, at 36.

[44] KRAAKMAN , *supra* note 17, at 186.

[45] Ibid.

to the dilutive effect such share issuance would have on the existing shareholders ownership stake which we will discuss in detail in the upcoming chapter.[46]

1.1.2. **The Mode of Payment**

Before discussing the mode of payment in the issuance of new shares, concepts relating to the share capital, par value, considerations and valuation methods are pertinent for better understanding of this concept.[47] When a company raises funds through the issuance of shares in return for considerations it makes up the "share capital" of the company.[48] This capital is an ever-changing amount which increases whenever a company issues share for consideration. [49]The value of the consideration that is to be received in exchange for the share issued is the subject of the contractual agreement between the company and allottee. [50]However, the face value of such shares may not be lower than the par value of the shares which are issued to the allottee. [51]

As a general rule in all jurisdictions the shares may be issued at a price equal to or great than their par value. [52] "A par value is the unit price the capital which is notionally allocated to each share at the initial incorporation stage."[53] In a country where there is a fixed capital requirement it is easier to determine the par value of shares however for the rest it is arbitrary.[54] The erratic

[46] Ibid.
[47] John Armour, *Capital Maintenance*, School of Law, University of Nottingham, and ESRC Center for research, university of Cambridge at 2.
[48] Ibid at 2.
[49] Ibid.
[50] Ibid.
[51] Ibid.
[52] CAHN & DONALD, *supra* note 24 , at 165
[53] Ibid.
[54] Definitions from Passtrak Series 7-General Securities Representative- License Exam Manual (Dearborn, 13th ed., 2002).

nature of this value does not attest to the current value of the shares in the company. [55]Therefore, a corporation can have 'par value'[56], 'book value'[57] and 'market value'[58].[59] The difference between the issued market price value and the par value is called a premium. [60]Consequently, the futile nature of the par value after the incorporation stage has made different jurisdictions to issue shares without a par value.[61] One example is the US which confers the board of directors with the discretion to label any type of amount on such shares. [62] The selling of a no par value to the public to be practicable it depends on the good will of the company.[63]

"Shares may be issued for considerations which are tangible or intangible properties or benefits to the corporation including cash, promissory notes, services to be performed, contracts for services to be performed or other securities of the corporation." [64]However, most jurisdictions rely on in cash and in kind contribution while disregarding the other types of contributions. [65]

Valuation of shares is done to identify the adequacy of the shares issued in exchange for the contributions made. [66] Cash contributions are simple for valuation due to their fungible nature unlike contributions in kind whose valuation will become a difficult task. In this case different jurisdictions differ on their view as to who should be appointed to value such contribution.[67]

[55] Ibid.
[56] Par value an arbitrary value a company gives at the incorporation stage. Definitions from Passtrak Series 7-General Securities Representative- License Exam Manual(Dearborn, 13th ed., 2002).
[57] Book value is the current liquidation value of a share measured by how much common shareholders would receive upon liquidation, Definitions from Passtrak Series supra note 54.
[58] Market value is supply and demand value which the price the company is selling its shares. Definitions from Passtrak Series supra note 54.
[59] Ibid.
[60] CAHN & DONALD, *supra* note 24, at 166
[61] DGCL § 153.
[62] CAHN & DONALD, *supra* note 24, at 166.
[63] Alred F. Conard, Corporations in Perspective (Foundations Press, 1976), at 11-18.
[64] MBCA§6.21(b)
[65] CAHN & DONALD, *supra* note 24, at 175
[66] Ibid at 176
[67] Ibid.

Taking the example of the US, under Delaware law the valuation of adequate consideration is done by board of directors which will remain conclusive unless fraud is claimed. [68]

When we come to mode of payment jurisdictions follow various approaches. [69] The jurisdiction under focus, U.S. Delaware statute, "corporations are allowed to issue "partly paid shares" and places no numerical restriction-such as one-half or one-quarter- on the amount that must be paid in at issue."[70] The core concept behind this is adequate consideration shall be received for the issued shares. [71] It is however possible for the company to receive part payments for such shares and the payments will be subject to assessment until fully paid. [72] When fully paid, the "shares are said to have been validly issued and fully paid and therefore non-assessable."[73] Whatever the contribution and type of payment made by prospective shareholder, the basic principle is shares shall be issued in parity with the value of the contribution made so as to avoid the dilution of the existing shareholders interest which will be discussed in the next chapter. [74]

1.2. **Corporate Securities**

Coupling to the ingenuity of corporate mentors and finical need of the corporation coupled with the demand of investors, nowadays, corporations are issuing complex securities[75] which can serve both as a "Control-Protector" and "Sweeteners". [76] When corporations opt to issue securities, different needs come into being: existing shareholder's needs, the investors' needs and

[68] MBCA§6.21(b).
[69] CAHN & DONALD, *supra* note 24, at 204
[70] DGCL § 156
[71] CAHN & DONALD, *supra* note 24, at 175.
[72] Eric A. Chiappinelli, case and materials on business entities (Aspen Publishers, New York, 2006) at 186.
[73] Ibid.
[74] CAHN & DONALD, *supra* note 24, at 175.
[75] Alexander H. Frey, Shareholders' Preemptive Rights (The Yale Law Journal, Vol. 38, No. 5(Mar., 1929), at 564.
[76] Chiappinelli, supra note 72 at 165.

company's needs.[77] To accommodate those needs in the possible way, different protections are afforded in terms of voting rights attachments, the rights corporation can exercise,[78] issuance of warrants and other options granted to incumbent owners/ managers and rights based on shareholders agreements. [79] This are deemed to be Securities as a "Control-Protector" corporations. "Sweeteners" are features of securities that make it salable for example the issuance of convertible securities, preferential shares, giving special voting rights, options to directors(derivatives) and giving special privileges based on shareholders' agreement(private deals).[80]

Ordinarily, corporations issued stocks which have a one vote per shares, right over net earnings and upon liquidation right over the assets proportionate to their holdings which are known as Common stock (ordinary shares).[81] However, "with the growing demand for additional capital plus the reluctance to borrow money, corporations were eventually induced to create a new type of shares"[82] which aided the holders to gain preference over common shareholders' bestowed rights and fixed dividend payments.[83] This type of stock is termed as preferred stocks. [84]

Preferred stocks are further broadened to accommodate different interests which lead to the according of conventional economic and voting rights. [85]Moreover, additional privileges relating to cumulative and participatory dividends rights which the former gives absolute right to payment of dividends and the latter right to participate beyond the stated preference was

[77] CHIAPPINELLI, *supra* note 72, at 152-153.
[78] Rights that can be exercised by corporations can be issue of new shares, repurchase rights, issuance of callable/redeemable shares. CHIAPPINELLI, *supra* note 72 at 156.
[79] Ibid.
[80] Ibid.
[81] Ibid.
[82] Frey, supra note 75 at 565.
[83] CHIAPPINELLI, supra note 72, at 152-153.
[84] Ibid.
[85] Ibid.

created.[86] In addition to these securities, securities with conversion privileges are created "to give a chance for debt security holders and preferred stock holders to hold a specially tailored property interest in the corporation that not only grants them participation in profit but also a number of control rights." [87]

1.3. **Vested Rights in Equity Ownership**

Ownership of a share in a company affords the owners of such securities with two fundamental rights: economic and voting rights.[88] On the other hand, the economic right in the company denotes the right to dividends, right to residual claims and anti-dilution rights.[89] First, "Dividends are excess earning (profits) of the company that is paid out periodically after other interests in debt securities are paid which are enshrined in the charter of incorporation of the company".[90] The division of power between shareholder and directors regarding the decision to declare dividends differ significantly in different jurisdictions.[91] For example, "in Delaware, the management has a sole discretion as to whether to declare dividends or not subject to the treat of not being re-elected"[92] or attacked by "abuse of discretion" by stockholders.[93] Whatever the jurisdictions case would be when Board of Directors declared dividends then the equity owners will have a portion of it.[94]

[86] Richard M. Buxbaum, Preferred Stock--Law and Draftsmanship, 42 Cal. L. Rev. 243 (1954). Available at: http://scholarship.law.berkeley.edu/californialawreview/vol42/iss2/2 at 243.
[87] Ibid at 279
[88] Kraakman, supra note 17, at 14.
[89] CHIAPPINELLI, supra note 72, at 152-153
[90] Buxbaum, supra note 86, at 250.
[91] Ibid.
[92] CAHN & DONALD, supra note 24 at 196.
[93] Id. at 253.
[94] Kraakman, supra note 17, at 12.

Second, right to residual claims is the right to receive (claim) leftovers of the assets of the corporation upon liquidation after the creditors has been paid.[95] Third, Anti-dilution rights which is the main area of focus this thesis, is a right of shareholders for their interest to remain intact by the activities of the corporation.[96]

The voting rights dictate the capacity to depict ones interest in the corporation's affairs.[97]These rights play a fundamental role in averting decisions made by the corporation that can affect shareholders interest.[98] Therefore, this power is highly beneficial when the corporation is making major decisions such as election of board of directors, making fundamental changes to the corporation such as merger and shareholders' resolution.[99] To facilitate this right of voting, different methods have been deployed. [100]Voting can be straight (one share one vote), cumulative (minority gets the possibility to elect board members directly or by proxy). [101]

[95] Residual claims is the notion that its holder is entitled to the value of whatever is left after all others with claim against the company are satisfied, Dana Gold, *Kent Greenfield [FNd1] Daniel JH Greenwood [FNr1] Erik S. Jaffe [FNa1] Copyright\copyright 2007 by the Seattle University Law Review; Kent Greenfield, Daniel JH Green-Wood, Erik S. Jaffe*, SEATTLE UNIVERSITY LAW REVIEW 53 (2007).
[96] Hills, Supra 8 *at* 2.
[97] *Id.*
[98] KRAAKMAN , *supra* note 17 , at 12
[99] *Id.* at 14.
[100] CAHN & DONALD, *supra* note 24, at 467
[101] Ibid.

CHAPTER TWO

PROBLEMS ASSOCIATED WITH STOCK SUBSCRIPTION AND THE PANACEA PROVIDED

PART I- PROBLEMS ASSOCIATED WITH STOCK SUBSCRIPTION

I.2.1. **Dilution**

Stock subscription through subsequent stock offering causes dilution to the existing shareholders ownership stake.[102] Dilution basically means reduction (decrease) in something which in this case can be percentage dilution or economic dilution or both.[103]

I.2.1.1. **Percentage dilution**

Percentage dilution occurs by the mere issuance of new shares and has an effect on the percentage of ownership the investor possesses.[104] As noted in the earlier chapter, equity ownership in a company confers rights as to voting, claims on earning and net assets upon liquidation.[105] The percentage dilution that will occur in this case basically affects this rights one of more so than others depending on the circumstances attached to the issuance of new shares. [106]

This type of dilution does not alter the economic value of the investors holding unless issued without a fair value. If the issuance is with a fair value it will increase the percentage of earning with the increase in capital.[107] However, the mere issuance of new shares has the potential to eliminate veto in connection to certain voting rights, diminishes the majority holding of an

[102] Ibid.
[103] LIANG, supra note 7 at 46.
[104] Michael A. Woronoff and Jonathan A. Rosen, *Understanding anti-dilution provisions in convertible securities,* 74(2005) at 134.
[105] Frey, supra note 75 at 152-153.
[106] Woronoff v. Rosen, supra note 104 at *134.*

[107] Ibid.

investor who has vested interest on such control and directly or indirectly tilts the balance of power. [108] This is as a consequence of the spreading of voting rights between shareholders. A to protect the interest of existing shareholders from this type of dilution many jurisdictions has provided preemptive rights which will be discussed in the next part and the upcoming chapter as a solution.[109]

2.1.2. **Economic dilution**

Economic dilution is a decline in the value of the investment due to the issuance of underpriced new shares which can be attributed to the market value decline and/or issuance below the par value. When measuring the economic dilution of shareholders' investment, two factors shall be taken into consideration: dilution on the initial (original) investment and dilution of the book value of the investment.[110]

Stock markets are unpredictable. There is always going to be increase or decrease in market price of stocks due to the supply and demand in the economy. Therefore, when considering these two factors to determine the economic dilution of the investors' ownership stake, taking the market price of (value) of such shares is vital.[111] For example, a share that is issued originally at a price of 1€ per value (initial investment) after some years may be worth 3€ per value (book value). If the company issues such share with a 2€ per value due to a decline in price in the market, though there is dilution *per se* the book value it is doubtful if it can triggers protections unless other f but not in the initial value.[112]

[108] Ventoruzzo, Supra note 3 at 525.
[109] Ibid.
[110] Ibid.
[111] Ibid.
[112] CHIAPPINELLI, supra note 72 at 152.

Additional requirements are set forth when considering economic dilution in cases of convertible securities which relates to decline in price of the convertible security and securities to be receivable upon conversion.[113] Different factors attribute to the decline of economic value in convertible securities. These are price of the security to be converted into, net value, price, agreed terms and conditions and risk free interest rates attached to it. To aid in the protection of the holder of such securities anti-dilution rules are provided thereof. [114]

I.2.2. **Watering of Stocks**

Payment for shares is made through the contractual arrangements made between the corporation and the allottee.[115] As a rule, corporations can only issue shares in parity with the contribution received. However, there are cases due to inflated valuation of such contribution or without reception thereof, corporations will issue new shares. This leads to "watering of Stocks". [116]

"Watering of stocks refers to shares issued as fully paid when in fact the consideration agreed to and accepted by the corporation's directors is something known to be much less than the par value of the shares or lawful subscription price."[117] Whenever corporation issues shares with an overvaluation of the property received or without receiving the par value of the shares issued, the shares issued are said to be watered to the extent of such overvaluation or underpayment.[118]

Watered stocks can occur for different reasons either intentionally or negligently. The first is, through the "issuance of bonus shares or inducements of bonds or preferred stocks".[119] Bonus shares are issued by corporation as an incentive to shareholders who have bought a large amount

[113] Ibid.
[114] Ibid.
[115] Armour, supra note 47 at 3.
[116] Cox & Hazen, Corporations, 2nd Ed. (2003) at 505.
[117] Ibid.
[118] Ibid.
[119] Ibid.

of stocks from the corporation without consideration. [120] "Bonus shares have been legitimized as a means of apportioning the consideration of the purchase price between corporation face difficulties in apportioning or allocation in the credit where the bonus shares are issued due to gratuitous nature of such stocks."[121]

The other is, when stocks are issued to stock holders in lieu of dividends without the existence of profit. For shares to be issued in exchange for dividends, the earning of "profit" is necessary. However, without the existence of such profit the corporation issues shares, the shares issued are said to be watered.[122]

In jurisdiction such as the US where part payments are possible with assessments and follow up attached to it until full payment due to the misleading accounts and financial statements that are accompanying watered stocks it will make this assessment impossible. [123] The statements provided in these documents are deceptive to the public, creditors and shareholders. Furthermore, it will create excessive reliance on the capital of the corporation.[124] In a corporation form where one of the attractive features is limited liability which demarcates the right of creditors for the exercise of their rights to the assets of the corporation, deprivation of such capital will have a drastic effect on their rights.[125]

Watering of stocks has been made the exception to the limited liability concept of shareholder in the U.S. legal system. This concept is perfectly illustrated by the Bing Crosby Minute Maid

[120] Ibid.
[121] Frey, supra note 75 at 119.
[122] Ibid.
[123] James C. Bonbright, *Shareholders' Defenses against liability to creditors on watered stock*, Columbia Law Review, Vol.25. No. 4(Apr. 1925), pp.408-433.
[124] Cahn &Donald, supra note 24 at 170.
[125] Bonbright, Supra note 123.

Corp. v. Eaton[126], and the legal theories for the creation of the liability of shareholders. In this case, the defendant transferred his sole business to a corporation where the corporation issued to him 3,478 shares with $10 per value and 1,022 shares were held for the defendant accompanied by the notion "escrowed". These shares were never released from escrow. After some time the corporation was faced with some financial problems which made it borrow money. However, the corporation upon insolvency was assigned for the benefit of the creditors and the plaintiff is made judgment creditor for $ 21, 246.42. Two issues were raised the first is whether the holder of the escrow shares could be made liable for the "water" and the legal liability for such watered stocks were framed.

The court held that,

> On the first issue, even if the defendant cannot transfer the shares in escrow, he become the owner of such shares when he was able to exercise his voting right because of the failure of the failure of the corporation to place any restrictions on the shares. On the second issue the court held that, there are two potential legal theories for the basis of the liability. One is statutory, where it is applicable to all creditors whether they have relied on the overstatement capital which is state specific. Second is Misrepresentation theory which requires reliance on misrepresentation for its application which in this case the plaintiff managers were aware of this facts, thus no reliance. [127]

The issue of watering of stock has declined due to the creation of no par value shares in the U.S. which deprived corporation for the set standard for valuation.[128]

[126] 46 Cal.2d 484, 297 P.2d 5(1956)
[127] Ibid.
[128] Cox & Hazen, supra note 116 at 505.

Part II- Panacea Offered

II. 2.1. **Preemptive rights**

When a corporation issue new shares in a subsequent stock offering to few existing shareholder or new ones, as noted earlier, dilution as to the voting control and interest in net asset and earning can occur.[129] Thus, to protect the interest of existing shareholders from such dilutions, different jurisdictions have afforded preemptive rights either mandatorily or as option. [130] Preemptive rights are sought to protect the interest of existing shareholders by offering them the right to ascribe to **any** new shares issued by the company **proportionate** to their holding prior to such shares being offered to the public. Therefore, the basis for the creation of this rights is maintenance of ownership stake.[131]

The exercise of preemptive rights and the mode of allocation of this rights to any new shares and proportionate to their holding has become a cause for concern due to the complexity of shares being issued nowadays.[132] As noted in the earlier chapter, share with various attributes attached to them have become "Sweetener" and "Control-Protectors" in a corporation. [133] Therefore, apportioning to existing shareholders' preemptive rights proportionate to their shareholding disregard of the class they belong to can sound impracticable and unjustified. [134]

The issues that fuel this concern are different arguments that are raised by different scholars. The first is, the speculative nature of dilution in some aspect of the ownership stake. This is due to the fact that, as mentioned earlier, when the capital of the capital of the company increases the

[129] Tibor Tajiti, Legal Aspects of corporate finance, 63(2014-2015)
[130] Frey, supra note 75 at 563-583.
[131] Ibid.
[132] Ibid.
[133] Chiappinelli, Supra note 72 at 152.
[134] Frey, supra note 75.

percentage of the net earnings and assets of each shareholder will also increase which devour the very idea of dilution.[135]

The second is, preemptive rights are said…

> …to have a cost. They delay issues of new shares by forcing companies to solicit their own shareholders before turning to the market. They also limit management's ability to issue blocks of shares with significant voting powers. Thus, due to the restraints they will cause to shareholders they should not be abandoned.[136]

The third is, the issue that was raised of the difficulty of apportioning of preemptive rights proportionate to their holding and to any type of shares. Thus, doing so its unfairness implication.

Some authors relaying on this arguments have suggested preemptive rights to be triggered when dilution to voting rights of existing shareholder occurs. Though this approach is deemed preferable, due to the difficulty of determining the effect of the issuance of new shares on classes of shares balance, it becomes a hypothetical one. [137]

II.2.2. **Anti-dilution Rules**

As noted earlier in the first chapter, one of the securities that are issued by corporations to attract investors is convertible securities.[138] These securities can be debt securities, preferred stocks and sometimes common stocks which by written contractual arrangements or 'other documents'[139]

[135] Ibid.
[136] Kraakman et al, supra note 17 at 186.
[137] Frey, supra note 75 at 564.
[138] Ibid
[139] Other documents that can create or evidence the creation conversion privileges are certificate of incorporation, trust indenture, deed of trust or other document. Hills, *supra* note 8, at 3.

can be given the privilege to convert into a different class of stocks. [140]For this exchange to take effect, forgoing of the original securities in lieu of the new securities to be issued is mandated.[141]

These procedures are facilitated by the written contractual agreements that beforehand delineate the terms and conditions for the exercise of such privileges like conversion price, classes and 'time of conversion'[142].[143] Typically, the conversion privilege is exercised by senior securities into junior ones which are mostly common stocks. The conversion is "calculated by dividing the initial purchase price (sometimes plus accrued but unpaid interest or dividends) by a fixed conversion price".[144] It is a problem that affects the value of the conversion privileges that necessitated the opening of the door for anti-dilution rules.[145]

"Anti-dilution provisions are designed to protect the holders of convertible securities against dilution from a large variety of corporate events, including among others, stock dividends and splits, cheap issuance of additional common stock and distributions of cash or property." [146]The dilution that occurs in this case can be percentage dilution or economic one.[147]Moreover, the economic dilution that can occur can be dilution to the convertible securities itself (dilution to the full economic value) or dilution to the value of the securities receivables upon conversion

[140] Buxbaum, *supra* note 86, at 279.
[141] Hills, *supra* note 8, at 1.
[142] The time for exercise of such conversion can exist for the life of the convertible security or for short period, either stipulated or contingent in length. In conversion time has no essence due to the "sliding conversion rate" that incentivizes the holder of such rights to react quickly. Thus, to escape from the falling of prices in such conversion rates the holder of those rights usually choose to exercise their rights quickly so specifying the time for such conversion become useless. Buxbaum, *supra* note 86, at 279.
[143] Buxbaum, *supra* note 86, at 279.
[144] Ibid.
[145] Ibid at 282.
[146] Hills, supra note 8 at 1.
[147] Ibid.

(dilution to the immediate exercise value). While preemptive rights cover the percentage dilution, anti-dilution provisions give protection to the economic dilution. [148]

Anti-dilution provisions are triggered in three dilutive events. These are structural changes in common stocks, issuance of new shares below the conversion price and distribution of cash or property.[149] These dilutive events will be discussed in detail hereunder.

II.2.2.1. **Structural changes in common stock**

Corporation in due time may choose to make structural adjustments to its common stock for various reasons.[150] These structural adjustments, to mention but a few, can be stock splits and combinations and reclassifications.[151] Though the capital structure of the company remains intact by these changes, they cause dilution on the securities to be received upon conversion by the holder of such privileges.[152] For example "when stocks are split into two one would expect twice as much securities to be handed to the convertible security holder when exercising conversion."[153] To protect the interest of the conversion privilege holder in such situations, alternations to the conversion price to afford the same percentage of ownership before and after such changes irrespective of the time of exercise is provided.[154]

There are two opposing interests in respect of such adjustments that need to be balanced by a corporation.[155] These are the interest of underlying security holders and the conversion privilege holders. [156] Price adjustment through the anti-dilution provisions while it protects that interest of

[148] Woronoff and Rosen, supra note 104 at 145.
[149] Ibid.
[150] Liang, supra note 7 at 49.
[151] Ibid.
[152] Ibid.
[153] Bauxman, supra note 86 at 262.
[154] Ibid.
[155] Ibid
[156] Woronoff and Rosen, supra note 104 at 145.

the convertible security holder, it diminishes the interest of underlying security holder. However, since common stock holders are protected by the fiduciary duty rule which is not extended to the convertible securities thus affording them protection through anti-dilution rules can be justified.[157]

II.2.2.2. **Sale of common stocks below the specified conversion price**

In the written contractual agreements that confer the conversion privilege, as noted earlier, conversion prices are fixed beforehand at the time of entering into contract.[158]These prices are part of the conversion instruments and are accompanied by specific class such right is to be exercised upon.[159] Accordingly, the corporation will be bound by such terms and conditions at the time of conversion.

When more new shares of convertible stocks or stocks such conversion is to be exercised upon are issued with a cheap price, dilution to the percentage and economic interest of the privilege holder will occur. This dilution is mended through the adjustment of the conversion price either *via* the "conversion-price formula" or "market-price formula". These formulas have their own underlying theories which are discussed below. [160]

II.2.2.2.1. **Conversion-price formula**

The conversion- price formula as the name indicates is necessitated when subsequent shares are issued below the initial conversion price. In the hopes of leaving the securities holder in an advantageous position series of arithmetical adjustment is to the conversion price. [161]

[157] Ibid.
[158] Ibid.
[159] Liang, supra note 7 at 49.
[160] Ibid.
[161] Woronoff and Rosen, supra note 104 at 145.

Owing to the fluctuation in the market price it is hard to determine whether the market failures that had an effect on the price of the shares the convertible security or the underlying security shall be attributed to the triggering mechanism for this formula or not.[162] Some argue that the market failure weakness the anti-dilution protection thus shall not trigger it while other attach such failures to company's failure to make accurate calculation and shall be covered by anti-dilution protection.[163]

A conversion-price formula can be either in the form of "full-ratchet" or "weighted average" forms. "These method used can have significant economic consequence."[164] Thus, choosing wisely is highly recommended.

II.2.2.2.1.1. **Full-ratchet approach**

The full-ratchet approach allows the downward adjustment of conversion price to the issued price.[165] This is done through allowing the conversion privilege holder to exercise their rights as if agreed upon the current conversion price. Two conflicting views reside in this formula. The proponents of this approach, for obvious reasons, are investors.[166] They base their argument on market failure occurring because of inaccurate calculations of the company's net worth on the basis of which the investors extends their finances. Thus, protecting investors which are decapitated from making an informed decision due to the asymmetry of information is mandated.[167]

[162] Ibid.
[163] Ibid.
[164] Ibid.
[165] Liang, supra note 7 at 49.
[166] Ibid.
[167] Ibid

Conversely, underlying security holders and founders of the corporation oppose this theory and raises the argument that this formula fails to take into account the number of shares issued at a cheap price. Moreover, they is argued market failures occur for different reasons which are uncontrollable, therefore, such costs shall be borne by all.[168]

Aligned to its capacity to transfer costs of the decline to common shareholders, this approach was typically used by venture capital deals due to the valuation gap and because the shareholders are the founders and managers. However, nowadays, "this approach is rarely being used except in riskier transactions or in periods of economic turmoil." [169]

II.2.2.2.1.2. **Weighted-average approach**

This weighted-average is calculated by weighting in the number of shares issued at a lower price by that of the average price. [170] In this approach:

> …the conversion price is reduced to the weighted-average price per share of securities issued (or deemed issue) both prior to and in the dilutive issuance, generally treating all stock outstanding (or deemed outstanding) prior to the dilutive issuance as being issued at the conversion price in effect immediately prior to the dilutive issuance.[171]

Consequently, the higher the shares issued at a cheaper price the higher the conversion price protection will be. This method bears in mind concert aftermath of the new securities on the company's capital. This makes it much more equitable to the non-investor shareholders compared to the full ratchet.[172]

[168] Ibid.
[169] Ibid.
[170] Lorenzo Sasso, *Capital Structure and corporate governance: The role of Hybrid financial instruments*, (2013) at 147.
[171] Woronoff and Rosen, supra note 104 at 147.
[172] Ibid.

Weighted average can be 'broad based' or 'narrow based'. The broad base looks at the overall impact of the dilutive issuance of new shares over the capital of the company and all outstanding shares that would be. On the other hand 'a narrow-based' only focuses on actually issued shares and how the dilutive event affected it. Through the narrow approach higher adjustment can be acquired.[173]

II.2.2.2.2**. Market-price formula**

The market-price formula which presumes equal footing of the conversion security holder and common stock holder provides protection where shares are issued below the market price.[174] This formula provides for a new conversion price which comprehends, "the ratio of both new conversion price and old one which is equal to the ratio of number of shares of common stocks that would be outstanding to that are actually outstanding before and after the dilutive event."[175]

If the shares outstanding are double what they ought to be taking into account of the money to be acquired and the market price prior to the dilutive issuance, the conversion price will be split into two. The protection that is afforded by this formula is on the basis of what market price says disregard of such market price belonging to the initial (original) investment or book value of the company.[176] The core concept here is whether the market price has been diluted or not. This takes the presumption that there is accurate market calculation of net value of the company initially. [177]

[173] Ibid.
[174] Marcel Kahan, Anti-dilution provisions in convertible securities, 2stan.J.L.Bus.&Fin.147(1995-96)
[175] Ibid at 151.
[176] Woronoff and Rosen, supra note 104 at 154.
[177] Ibid.

II.2.2.2**. Distribution of cash or property**

Economic dilution will occur by virtue of the distribution of cash or property by a company to its common stockholders which will result in the decline in the value of the net worth of the company.[178] This done through "siphoning off profit or assets of the company."[179] This is a typical anti-dilution protection that needs to be provided to all convertible securities to be issued.

The protection that is provided under this formula takes into account what the convertible security holder would receive upon conversion "with respect of each share of common stock issuable upon conversion prior to the distribution, the shares plus and a number of additional shares with a value equal to the per share distribution (with these additional shares valued at the pre-distribution market price less the amount of the distribution)".[180] "This protection is afforded by reducing the conversion price which leads the holder of such shares obtain additional shares equal in value to the losses per share caused by the dilutive distribution."[181]

[178] Ibid.
[179] Ibid.
[180] Ibid at 154.
[181] Liang, supra note 7 at 51.

CHAPTER THREE

THE APPLICABILITY OF PREEMPTIVE RIGHTS AND ANTI-DILUTION RULES IN THE US AND THE VIABILITY OF ADOPTING SUCH RULES IN ETHIOPIA

Part I- Preemptive Rights and Anti-dilution Rules Applicability in the US Legal System

3.1. **Statutes**

In the US, preemptive rights have come a long way from being mandatory law to a default rule which parties may opt for.[182] Though it is not the first case to raise the issue of preemptive rights in the US, the case of Stokes v. Continental Trust Co. of New York[183] appears to be the most pertinent. The issue in the case turned on whether the plaintiff had a legal right to subscribe for and take the same number of shares of the new stock proportionate to his previous held shares of stock. The court reasoned that:

> [A] stockholder has an inherent right to a proportionate share of new stock issued for **money only** […..] and while he can waive that right, he cannot be deprived of it without his consent […..]. The stockholder can waive his right by failing to do what he ought to have done, or by doing something he ought not to have done. Example is by failing to attend a shareholders meeting after being duly notified.[184]

This position taken by the court has now changed. Currently, the default rule is that there is no preemptive rights in the US irrespective of the structure of ownership: public or closely-held corporations. The only way the law will recognize the preemptive right of shareholders is if enshrined under the charter of incorporation. [185] § 6.03 MBCA confirms the "no-preemptive right" rule unless specified in the charter of incorporation but further lists the grounds on which the board may provide for such rights as follows:

[182] Ventruzzo, Supra note 3.
[183] 186 N.Y.285, 78N.E. 1090(1906).
[184] Ibid.
[185] 8 Del.Corp. § 102(2(b) (3).

> The shareholders of the corporation have preemptive rights granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the rights, to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them.[186]

The safety mechanisms which the US law provides to shareholder to thwart opportunistic behaviors are the fiduciary duty of directors which is aided by *ex post* legal remedies, special corporate forms and other bodies of law such as Securities and Exchange Commission which will regulate themselves.[187]

3.1.1. Fiduciary duties

Directors are bestowed with the power to manage and handle the business of a corporation.[188] With such powers come responsibilities. One of them is, the fiduciary duty directors owe to shareholders denoted by the duty of loyalty, duty of care and duty of disclosure.[189] This is best expressed "by acting prudently and [in] the best interest of the corporation rather than their own." [190] Generally, there is no close scrutiny by the courts of the decision of directors unless there is a claim of misconduct, breach of duty of loyalty. If shareholders believe there is a breach of such duties, they can bring derivative suits to courts. This is to protect shareholders from opportunistic behaviors that will affect or dilute their interest in the corporation. [191]

The Delaware law states that:

> contract or transactions between a corporation and one or more of its directors or officers [or any entity in which they serve or that they own] is protected against challenge regarding the interest if "the material facts'' regarding the transaction are disclosed, and the transaction is either (1) approved by the majority of disinterested

[186] Model Bus. Corp. Act § 6.03(b) (1).
[187] Kraakman, Supra note 17 at 25.
[188] DGCL§ 141(a).
[189] Ball C.,Sonnie M. & Triponel A., Merger and Acquisitions: Trends and Developments, 2010,(137-230).
[190] Ibid.
[191] Ibid.

> directors or the majority of the shareholders in good faith, or (2) "fair to the corporation as of the time it is authorized, approved or ratified. [192]

Rules with similar effect apply in the Model Act Law. [193]

In the *ex post* legal remedies, the standard used by courts to settle this issues are on the basis of factual situations which the intervention is based on "fair", "reasonable", "adequate" and "disinterested". [194] The use of standards by the Court as a means of resolving these issues "will leave the precise determination of compliance to adjudicators after the fact in their hand."[195] These standards require the judge to use "mature and trained judgment" in determination of the compliance of such standards and taking account of the factual circumstances of the case.[196] If breach on the side of the directors is detected, the courts remedy the shareholders through the disgorgement of profits derived by the officer or director.[197]

To sum up, "Enforcing duty of loyalty is costly and litigation-intensive, but it is likely to provide small minority shareholders with better protection than preemptive rights do."[198]

3.1.2. Special corporate forms and other bodies of law

Corporate forms in the US are regulated by laws that either deduced from their special corporate form or other bodies of law. [199] Special corporate forms division includes different corporate forms. One is closely- held corporations.[200] A closely-held corporation is "one in which the

[192] DGCL §144(a).
[193] Cahn and Donald, supra note 24 at 344.
[194] Ibid at 346.
[195] Ball and Triponel, supra note 189 at 142.
[196] Kenneth W. Dam, "Equity Markets, the Corporation, and Economic Development" (John M. Olin Program in Law and Economics Working Paper No. 280, 2006).
[197] Ibid at 14.
[198] Kraakman et al., supra note 17 at 196
[199] Ibid at 16.
[200] Ibid at 17

capital is held by a few individuals, a few families, and, in any case, rarely changes."[201] The main identifying features of these corporations are restrictions on free tradability, the possibility of majority holding and the possibility of shareholders and mangers being one and the same.[202]

To attract investors and potential financiers, closely-held corporations though they are only obliged to disclose financial reports to shareholders[203], in practice, they willfully comply with procedures of submission to private creditor's bureaus of their financial information and reporting in the GAAP accounting principles.[204] These voluntary procedures are a means of self-regulatory procedures which creates confidence for the market and the shareholders.[205]

As opposed to closely held companies, mandatory disclosure requirements are imposed on publicly held companies. Under the U.S. law reporting and "disclosing as to all the material information bearing on the value of the issue and the issuer's financial condition in a registration statement filed with the Securities and Exchange Commission (SEC) is required." [206] Furthermore, "periodic filing requirements prepared in accordance with GAAP and report immediately on material developments" must be fulfilled also.

On the other hand, other bodies of law are bodies of law that aid in the functionality of the corporate statute such as Securities and Exchange Commission (SEC). "The SEC regulates publicly held companies through disclosure requirements and facilitation of the sale and resale of securities, merger and acquisitions and corporate elections."[207] This law offers corporations

[201] Colin Mcfadyea, *The American Close Corporation And Its British Equivalent*, The Business Lawyer, Vol. 14, No. 1 (November 1958), pp. 215
[202] Ibid.
[203] Revised Model Business Corporation Act §2.02(a).
[204] Kraakman et al. , Supra note 17 at 125
[205] Ibid.
[206] Ibid.
[207] Ibid, at 18

more specifically for 'exchange-listed firms' a means to regulate themselves.[208] Stocks prices listed in the stock exchange are the manifestation of the corporation's performance. [209] If stock prices are high which denotes the director's performance in the wealth of the company and the corporation is doing well.[210] The reverse is true if stock when stock prices are low. [211] For this reason, Corporation are incentivized in the performance of their corporation and how and who manages it. [212]

To sum up, the special corporate forms & other regulatory bodies such as the SEC through their regulatory procedures which corporations voluntarily or mandatorily comply with, creates the opportunity for shareholder to monitor the opportunistic behaviors within the corporation.[213] It is a system by which it provides self-regulation where the market regulates the company which relieves the burden of the shareholder to keeping an eye on the company. [214]Moreover, especially for publicly traded companies if there ever is a case where their interest of ownership will be diluted, maintaining their ownership interest is a "click-away".[215] Meaning they can simply go to the stock market and buy more shares.[216]

For those shareholders who still feel the need for further protection especially in areas where the law lags, preemptive rights and anti-dilution rules are provided on contractual basis.[217]

[208] Ibid.
[209] Ibid.
[210] Ibid.
[211] Coline, supra note 201 at 215.
[212] Kraakman et al. , Supra note 17 at 125.
[213] Ibid.
[214] Ibid.
[215] Ibid.
[216] Ibid.
[217] Woronoff and Rosen, supra note 104 at 145.

3.2. **Contracts**

Contracts play a quintessential role in the US corporate form especially in setting and creation of relationship among and between the firm's participants i.e. shareholder, directors and managers.[218] Moreover, it structures the terms of governance, explicitly or implicitly, with employees and creditors.[219]The predominant form of contract in U.S. corporate law is the charter of incorporation.[220] The charter is supplemented by "bylaws"[221] and "shareholders agreements"[222].[223]

The article of incorporation, as stated in the earlier chapter, must specify the share capital of the corporation which includes the number and kinds of shares that the corporation is "authorized to issue"[224].[225] The authorized shares set by the charter of incorporation play vital role in connection with the issue of dilution and whether the protective measures can be triggered.[226] This shares which the shareholder have given prior consent to for the directors to do their bidding, it's only when there is a need of "*over issue"*[227] of shares or change to this class of shares authorized that the issue of dilution and protective measures to shareholders arise.[228] Furthermore, this changes cause the amendment of the charter of incorporation due to their

[218] Kraakman, supra note 17.
[219] Ibid.
[220] Ibid.
[221] Bylaws are set of laws which govern less fundamental matters and are subject to different and generally more flexible amendment rules. They are rules for internal governance of a corporation. Kraakman , supra note 17 at 19.
[222] Shareholder Agreements is a means where a perspective shareholder can impose its vesting terms and mechanism to ensure its rights will be preserved in all cases except situations mandated by law. http://www.investopedia.com/terms/s/shareholdersagreement.asp
[223] Kraakman, supra note 17 at 19.
[224] In the US, the law makes a difference between authorized shares and issued shares. Authorized shares are shares the Corporation is authorized to issue by the charter of incorporation. On the other hand, issued shares are shares that are in the hands of investors. CHIAPPINELLI, supra note 72 at 185.
[225] MBCA §§ 1.40(2), 2.02(a) (2) and 6.01(a), and DGCL §102(a) (4).
[226] Ibid.
[227] Over issued shares are shares that are issued above the authorized share. Chiappinelli, supra note 72 at 185.
[228] Supra note 225.

fundamental nature which requires majority voting from shareholders. [229]Thus, the working ground for Preemptive rights and Anti-dilution rules are the changes that are made to the charter of incorporation. [230]

The restriction on shareholder rights on the authorized shares has two exceptions attached to it.[231] One, if the shares are issued other than cash and the voting power of shares that are issued comprises more than 20% of the voting power of the outstanding shares.[232] Second, "U.S. listing requirements for exchange traded firms which require a shareholder vote when there is a new issue of shares large enough to shift voting control over a listed company's board of directors, unless the new issue takes the form of an offering to dispersed public shareholders."[233]

The authorized stocks in the charter of incorporation are set bearing in mind the future needs of the corporation for stocks. [234] Thus, usually they are set high. [235]Stated otherwise, the capital to be issued may be the "tip of the iceberg" when comparing it to the authorized shares.[236] Within such limits the power to issue new shares is given to the board of directors.[237] This set limit of authorized share in the charter of incorporation, the writer believes, has two purposes. First, it delineates the power of the board to issue new shares. Second, it demarcate the line were shareholders cannot intervene in the issuance of new shares.

[229] Kraakman, supra note 17.
[230] Ibid.
[231] Kraakman, supra note 17.
[232] M.B.C.A.§ 6.21(f).
[233] Kraakman, supra note 17.
[234] Ibid.
[235] Ventoruzzo, supra note 3.
[236] Kraakman, supra note 17.
[237] MBCA§6.21(b) and DGCL §161.

Whenever the management proposes to issue new shares, the board will approve such share issuance for adequate consideration within the limit of the authorized shares.[238] The approval requirement by the board is mandatory as can be inferred from the case Kalageorgi v. Victor Kamkin, Inc.[239] where the court held that formalities do matter to create predictability and uncontested rights.[240]

3.2.1. Contracts in Preemptive Rights

Preemptive rights, as noted earlier in this chapter, are only applicable if enshrined in the Charter of Incorporation.[241] This right is afforded to shareholders as an 'opt-in'[242] in almost all jurisdictions of the U.S. [243]Stated otherwise, unless negotiated for such protections, shareholders will not be protected from the issuance of new shares and the dilutive effect to their ownership stake.[244] The presumption here is parties who want to benefit from such protection will contract for it.[245] Moreover, there is a presumption that the parties who negotiate the charter have full knowledge of the law and their rights. [246]

One of the problem that is mentioned in the last chapter when discussing about preemptive rights is the application of **any** and **proportionate** exercise of preemptive rights whenever a company issues new shares.[247] This is aligned to the complexity of the shares being issued nowadays.[248] To resolve this problem, the M.B.C.A., the writer believes, has put in place a term that favors

[238] Ibid.
[239] (Del. Ch. 1999).
[240] Ibid.
[241] 8Del.Corp.§ 102(2(b)(3)
[242] Opt-in means unless the parties specifically enshrine this right in the charter of incorporation, they do not exist. Ventoruzzo, supra note 3 at 519
[243] Ventoruzzo, Supra note 3 at 522
[244] Ibid.
[245] Ventoruzzo, supra note 3 at 522
[246] Lorenzo, supra note at 155.
[247] Frey, supra note 75 at 564
[248] Ibid.

voting rights as a basis for affording preemptive right with exception to preferred stocks.[249] For any class holder to exercise his preemptive rights over new preferred stock issued, having voting rights and belong to the domain of preferred stock is necessary.[250] The exceptions to this exception are where preferred stock is convertible or carry a right to subscribe for or acquire shareholders without preferential rights.[251]

The exercise of preemptive rights depends on the willingness of the shareholder to make use of it. [252] If the shareholders with preemptive rights choose not to exercise this rights, the next step is determining what happens to those shares and whether it can be transferred to other shareholder with preemptive right and willing to pay. The answer to this question lies in M.B.C.A. where it specifically states that shareholders can only exercise their rights pro-rate and if there is any leftover it is up to the directors of the company to choose to sell it to outsiders.[253]

> The preemptive right of shareholders in connection with an issue of convertible obligations is not satisfactorily defined in the statute or decision law, but there is authority for the statement that shareholders have a preemptive right to subscribe for convertible obligations to the same extent that they would have a right to subscribe for the shares of stock into which such securities are convertible.[254]

As noted earlier, preemptive rights come with a cost of delay in liquidity of shares, restrictions on director's powers and proscription in fresh capital.[255]Consequently, most U.S. corporations, in practice, have chosen not to insert such protections in their charter of incorporation. [256]This is more so when it comes to public corporations.[257] Withal, one can infer from their public nature

[249] MBCA§6.30(b) (4), (5).
[250] Ibid.
[251] Ibid.
[252] Ventoruzzo, supra note 3 at 520
[253] MBCA§6.30(b) (6).
[254]Hills, Supra 8 at 21.
[255] Kraakman, supra note 17 at 196.
[256] Ibid.
[257] Ibid.

and high liquidity of shares by virtue of their listing in stock-exchange, any shareholder who wants to maintain his ownership interest can simply choose to buy more shares from the stock market.[258] However, for close-corporations this is not the case.[259] Consequently, they are presumed to be more inclined to use preemptive irrespective of what the practice reveals.[260]

3.2.2.1. **Exempted issuance**

Even though, preemptive rights are enshrined under the charter of incorporation, they are subject to certain restrictions on their applicability.[261] This leads to our discussion on "exempted issuance"[262]. The first is, shares issued for consideration in kind.[263] As noted earlier in the previous chapters, one of the modes of payment for shares is contribution in kind.[264] Whenever, a corporation issues shares so as to acquire assets of another or business, there is no preemptive rights attached to for in kind contribution unless specific in the charter of incorporation.[265]

Second is, shares issued for employees as part of the compensation scheme such as stock options.[266] Under the MBCA unless and otherwise specifically provided for in the charter of incorporation there is no preemptive rights for stocks issued as part of the compensation scheme for employees, directors and managers.[267]

[258] Ibid.
[259] Ibid.
[260] Ibid.
[261] MBCA§6.30(3).
[262] Exempted issuance typically means issuances of issuer's securities that are exempted from certain provisions such as Preemptive rights and Anti-dilution rules in security holder's agreements and related agreements.
[263] MBCA§6.30(iv)(3).
[264] CAHN & DONALD, *supra* note 24.
[265] MBCA, supra note 278
[266] MBCA§6.30(i)(3).
[267] Ibid.

Third is, stock offering in connection with acquisitions or mergers or strategic partnership. [268] Merger and acquisitions (abbreviated M&A) refers to:

> … the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity. [269]

Whenever corporation chooses to issue shares to accommodate the acquiring corporation and merger corporation's needs, no preemptive rights can be exercised. [270] This is because allowing existing shareholders to exercise their preemptive rights will dramatically affect the very purpose the merger. [271]Thus, the law prohibits exercise of preemptive rights in such activities unless and otherwise specifically stated in the charter of incorporation.[272] In most cases, since shareholders are protected by the rights of appraisal and duty of care and loyalty, precluding them from exercise of their preemptive rights is nothing short of the right decision. [273]

The fourth, preclusion relates to treasury stock.[274] As we have mention earlier, this are stocks the company reacquired for different purposes. [275] This stocks are stocks which are already issued and the question arise should the reissuance of such stock trigger the preemptive rights of existing shareholders.[276] Many courts held that since shareholders have already consented to the issuance of these shares in the first place and probably forgo their rights, allowing them to

[268] MBCA§6.30(ii)(3).
[269] Tibor Tajti, Legal Aspects of Corporate Finance, Central European University (2014/2015), at 229.
[270] Frey, Supra note 75 at 579
[271] Ibid.
[272] MBCA§6.30(ii)(3).
[273] Ventoruzzo, supra note 3.
[274]Frey, supra note 75 at 583
[275] Ibid.
[276] Ibid.

exercise preemptive rights again will be in unfounded.[277] Thus, no preemptive rights are allowed for treasury stocks.[278]

3.2.2. **Contracts in Anti-dilution Rules**

"The conversion privilege is a contract, whether it is construed as an option or as a continuing offer", both the shareholders and the corporation must be bounded by the terms and conditions of the privilege.[279] The charter of incorporation shields the interest of shareholder from the activities of the corporation that upsets the value of the conversion privilege.[280] As noted earlier these actions may arise from structural changes in common stocks, cheap issuance of common stocks and distribution for cash or property.[281]

The holders of conversion privilege are not afforded to protections for the actions that trigger dilution to their interest by dint of their privilege.[282] Unless and otherwise, the parties opted and negotiated for such protection in the conversion instrument and the inclusion or mention of it in the charter of incorporation, they are not protected by default rules. [283]Thus, contracting for such terms covering all contingencies is the vital condition to trigger anti-dilution protections in U.S. [284] This attests to the reality that the predominate laws in the protection of conversion privilege holder is contacts than the Law in U.S.[285]

It is of heightened importance that shareholders eschew all and any form of ambiguity in the contracts to avoid situations where the post-contract action of management (especially when

[277] Ventoruzzo, supra note 3 at 525.
[278] Ibid.
[279] Buxbaum, supra note 86 at 279.
[280] Ibid at 282
[281] Woronoff and Rosen, supra note 104 at 134-155.
[282] Buxbaum, supra note 86 at 282.
[283] Hills, Supra 8 at 21.
[284] Ibid.
[285] Ibid.

faced with distress) may operate to interfere with the rights of the shareholder.[286] This is illustrated in the court's decision in Kaiser Aluminum v. Matheson[287] which offered panacea for ambiguous contracts. In this case, Kaiser Aluminum Corporation ("Kaiser"), its directors and its controlling stockholder, MAXXAM, Inc., appealed from a grant of preliminary injunction in preventing Kaiser from implementing a recapitalization plan. The Recapitalization would create two classes of stocks which necessitates the amendment of certificate of incorporation reclassifying the authorized shares.

The Ambiguous provision at issue was:

> (i) If the Corporation shall
> (4) *Issue by reclassification of its shares of Common Stock any shares of common stock of the Corporation*
> Then, …[the conversion rate]…shall…be adjusted so that the *holder of a share of PRIDES shall be entitled to receive, on conversion of such share of PRIDES, the number of shares of common stock of the Corporation which such holder would have owned or been entitled to receive* after the happening of any of the events described above had such share of PRIDES been converted…*immediately prior to the happening of such event…*

The court framed two issues. The first is, how to interpret an ambiguous contract. The second is, in an indenture which is due to its nature prevents resort to extrinsic evidence to determine the parties' intent as indentures are not product of "normal" negotiations(borrowers are not involved) and are based on boilerplates[288] any understanding as to which would undermine the working of capital markets.

In its Holding, the court held that:

[286] Sasso, supra note170 at 155.
[287] 681 A.2d 392(Del.1996)
[288] Boilerplates is the standardization of a legal document's structure and language. This leads to quicker and more efficient practices in terms of the filling out and processing of documents. www.investopedia.com (last visited at March 28, 2015)

> …ambiguous contracts in the form of an indentures are to be interpreted contra proferentem (i.e. against the drafter) and by respecting the reasonable expectations of the investors we had subjected themselves to terms of the contract by purchasing the security.

This case serves as a caution to when drafting conversion instruments and the due diligence that need to be put in it.[289] A similar decision was rendered Parkinson v. West End St. Ry. Co. where Mr. Justice Holmes held:

> A convertible instrument imposes no restriction upon the obligor in regard to the issue of new stock, although the issue may be upon such terms as to diminish the value of the right. It is simply an option to take stock as the stock may turn out to be when the time for choice arrives. The bondholder does not become a stockholder by his contract in equity any more than at law. [290]

3.2.3. Application of Preemptive rights and Anti-dilution rules in Contracts

Preemptive rights and anti-dilution rules, as noted in the earlier chapters, are mechanisms that protect the interest of shareholders from dilution to percentage and economic interest of their ownership stakes.[291] Preemptive rights are mostly used to protect the interest of existing shareholders percentage of ownership that can occur by the mere issuance of new shares.[292] On the other hand, anti-dilution rules shield the economic interest of shareholders and convertible security holders from dilution.[293] Aforesaid, anti-dilution rules it is not always the case that the convertible securities are equity securities.[294] It can also be debt securities also. Thus, it extends its umbrella to host the needs of all security holders.

[289] Hills, supra note 8 at 2.
[290] Ibid.
[291] Ibid.
[292] Ventoruzzo, supra note 3 at 512.
[293] Michael A. Woronoff and Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 Fordham L. Rev. 129 (2005) at 134.
[294] George S. Hills, Convertible Securities-legal Aspects and Draftsmanship, 19 Cal. L. Rev. 1 (1930) at 21.

It is not always the case that the dilution will trigger anti-dilution rule. [295] It may only affect the percentage interest of ownership thus will only necessitates the measure in preemptive rights.[296] Thus, contracting for both protections can be highly beneficial to investors or shareholders and creates a high flexibility and option to exercise their rights.

These protections complement one another and provide a vehicle where parties have an option to choose from.[297] This is perfectly illustrated in the case Telcom-SNI Investors, LLC v. Sorrento Networks, Inc.[298] In this case, the court held that for one of the arguments the defendant raised the right of first refusal deletes the anti-dilution rule, the court ruled that

> The right to purchase on a pro rata basis any newly issued shares does provide a rational means for addressing anti-dilution concerns. However, because a holder may have the right to purchase new shares does not necessarily lead to the conclusion that those protective provisions of the Certificate do not serve anti-dilution function. If nothing else, the right of first offer provides an option to the holder who proposes the issuance of additional shares of … even if the holders of a majority of outstanding shares approve the issuance of additional shares. [299]

It is of high importance to note since these rights are the subject of contract; contract drafting plays a fundamental role in their existence and the purpose for their creation.[300] Thus, the rights and limits on such contracts shall be constructed "expressly and clearly' and will not be 'presumed or implied'."[301]

[295] Woronoff & Rosen, supra note 293 at 135.
[296] Ibid.
[297] 2001 WL 1117505(Del. Ch., Sep 7, 2001).
[298] Ibid.
[299] Ibid.
[300] Sasso, supra note 170 at 155.
[301] Ibid.

Part II-The viability of adopting preemptive rights and Anti-dilution rules in light of the US Laws

3.1. Increasing Capital

In Ethiopia, the share company is one form of business organization in which, in principle, its "capital is fixed in advance and divided into shares."[302] The law recognizes both forms of companies: public and closely-held share companies.[303] The former is formed through public subscription while the latter between founders. [304] According to the 1960 Commercial Code of Ethiopia, for a share company to increase its capital through the issuance of new shares which requires the amendment of the article of incorporation, two cumulative requirements needs to be met.[305] The failure to meet these requirements will lead to the invalidation of such issuance.[306]

The first requirement is that powers be delegated to the directors by the shareholders.[307] When the need for capital issuance of new shares occurs, the shareholders by an "extraordinary general meeting"[308] will authorize the directors to increase the capital.[309] Additional requirements are set when the approval through a "special meeting"[310] is mandated.[311] For this authorization to have effect, it is required that capital increase takes place within five years "unless the increase is through convertible debentures."[312] The code has specifically prohibited prior authorization to the directors in the memorandum and article of association which necessitates the need of approval

[302] Commercial Code, supra note 10 at Article 304.
[303] Gebremeskel supra note 12 at 47.
[304] Ibid at 100.
[305] Com. Code, supra note 10 at Article 464-483.
[306] Gebremeskel, supra note 12 at 100.
[307] Com. Code, supra note 10 at Article 465.
[308] Extraordinary Shareholders' meeting is a meeting that comprises of shareholders of all classes. Unless otherwise provided by law, it is only through this meeting that the amendment of the article and memorandum of association is possible. Article 390(2), (423) Com. Code.
[309] Hills, Supra note 8 at 21.
[310] Special meetings comprise only shareholders of a specific class. Article 390(3) Com. Code.
[311] Com. Code, supra note 10 at Article 426.
[312] Ibid, Article 466.

for every new share issued.[313] Unlike the US the Ethiopian commercial code provides that authorized capital is deployed only during the increase of capital.[314] During the incorporation stage, "subscribed" and "paid-up" capital are in use as can be inferred from Article 313(5) of the Commercial Code.

Secondly the capital has to be fully paid before the issuance of new shares.[315] At the formation stage, one of the requirements that is set forth by the law is that the capital be fully subscribed and at least one quarter of the par value of shares to be paid.[316] In order for the capital increase to have effect, this subscribed capital which is partly paid need to be fully paid.[317]

The issuance of new shares shall be in accordance with the rules regulating the formation of share companies.[318] Consequently, the company need to decide in advance the various kinds and classes of shares to be issued, their par value and the preferences attached to them.[319] Therefore, the next step will be deciding what type of securities to issue and the rights attached to them.[320]

3.2. Corporate Securities

A corporation, as noted earlier, has to set in advance the various kinds and class of shares, their par value and the preference attached to them.[321] It is only on the basis of these set criteria that the shareholders in the extraordinary general meeting will decide on the increase of capital.[322]

[313] Ibid, Article 465(2).
[314] Gebremeskel, supra note 12 at 103.
[315] Com. Code, supra note 10, Article 467.
[316] Ibid, Article 321(1(a) (b)) Com. Code.
[317] Hills, supra note 8.
[318] Com. Code. Supra 10, Article 468.
[319] Article 312-346 Com. Code.
[320] Gebremeskel, Supra note 12 at 83.
[321] Woronoff and Rosen, Supra note 104 at 134.
[322] Ibid.

Under the Commercial Code of Ethiopia, four types of securities are recognized and issued. [323] Among those, the widely used and favored type of share for its ease for accounting purposes is the ordinary (common) shares.[324]These shares basically attached with right to dividends and net assets upon liquidation, right to vote, right to purchase new shares prior to public offering proportionate to their holding and right to inspect the company's documents.[325]

The second type of share which is devoid of voting rights and has priority over enshrined rights of common stocks is preferred stocks.[326] The law provides for exceptional situation where such shares may be granted voting rights where it involves issues in general meeting. The third type of share is shares that are only given the right to participate in dividends which is in excess of statutory interest.[327] This is called dividend shares. Fourth type of securities is convertible debentures which are debt securities.[328] This security is subject to prior approval of an extraordinary general meeting.[329] For this type of share to come into existence, the renunciation by existing shareholders of their preemptive rights, a report by directors and auditors is mandated.[330] This privilege may be exercised at the option of the holder of such privilege or the company.[331] Depending on the contractual arrangements made between the company and the holder of such privileges, the company can increase its capital equivalent to the amount of the converted debentures.[332]

[323] Com. Code. Supra 10, Article 335-337.
[324] Gebremeskel, supra note 12 at 83.
[325] Com. Code. Supra 10, Article 345.
[326] Ibid, Article 336.
[327] Ibid, Article 337.
[328] Gebremeskel, supra note 12 at 86.
[329] Com. Code. Supra 10 at Article 304(1)) and Article 313(6).
[330] Ibid, Article 474.
[331] Gebremeskel, supra note 12 at 87.
[332] Ibid.

As can be inferred from the type of securities issued in the country and the practice share offering by these companies, the stock market in Ethiopia lacks diversity and fails to accommodate the needs of investors.[333] The other contributing factor for the lack of diversity in shares offered is, the law mandating shares to be issued with the same par value and identical rights.[334]

As the mode of payment the law recognizes both in cash and in kind contribution with the specific requirement of the shares issued in exchange to be in parity with the amount paid.[335] To validate this need a valuation requirement is set under the Proclamation 376/1995 Article 5(11) that amended the Article 315 of the commercial code. This valuation is done by shareholders in accordance with the procedures provided for private limited companies.[336]

3.3. Vested Rights

Under the Ethiopian Commercial Code, shareholders are vested with five inherent rights that are attached to their mere shareholding in a company.[337]These are right to participate in annual net profit, right in the net asset of the corporation upon liquidation, right to vote, right to inspect the documents of the company and preemptive rights.[338] The first of this rights is, the right to participate in annual net profit of the company paid in the form of dividends. [339]Dividends are paid to the shareholders whenever there is profit at the end of the year. However, the law has to

[333] Ibid at 88.
[334] Com. Code. Supra 10 at article 326.
[335] Ibid, article 315& 338.
[336] Ibid, Article 519.
[337] Ibid, Article 345.
[338] Ibid.
[339] Ibid, Article 458

provide for situations at the period of preparatory work and construction of the enterprise for profit which are not net profits of the company to be paid to the shareholders.[340]

The second is, the right to distribution of assets.[341] Shareholders have a residual claim over the assets of the company which after the payment of the liabilities of the company, the law requires surplus assets available to be distributed on each shares.[342] This is done on the basis of the hierarchy that exists between preferred shareholders and common shareholders.[343]

The third is, the right to vote.[344] With the exception of preferred stocks, the voting rights attached to shares are required to be proportionate to the amount of capital represented.[345] Every share carries with it at least one vote.[346] There is a possibility for the memorandum and article of association to limit the voting rights of all classes of shares in the general meeting.[347] However, such limit shall be applicable to all.[348]

The fourth is, the right to inspect documents of the company by shareholders.[349] The law requires the company to keep documents relating to its balance sheet, profits and loss at the head office so that whenever shareholder want to inspect such documents it will be available.[350]

Lastly, shareholders are afforded with the right to purchase new shares prior to public offering proportionate to their holding. [351] This right will be discussed in great detail in the next subsection.

[340] Gebremeskel, supra note 12 at 87.
[341] Ibid, Article 326.
[342] Ibid, Article 504.
[343] Ibid.
[344] Ibid, Article 326.
[345] Ibid, Article 407.
[346] Ibid, Article 407
[347]Ibid, Article 336(2), 337(2).
[348] Ibid.
[349] Ibid, Article 406.
[350] Ibid.

3.4. **Preemptive rights and Anti-dilution Rules in Ethiopia**

3.4.1. **Statutes**

Preemptive rights are one of the inherent rights that the Ethiopian commercial code affords by the mere fact of being the holder of any type of shares. [352] The law confers on existing shareholder mandatory preemptive rights proportionate to their shareholding to any new shares issued by the company.[353] These rights are transferable or assignable either for free or for cash considerations.[354] This transfer or assignment of rights shall be done in the same condition as the shares itself during the period of subscription.

The exercise of preemptive rights depends on the willingness of the right holder to make use of such rights.[355] If a shareholder with preemptive rights fails to make use of such rights for any reason, this rights can be allocated to those shareholder who requires more shares than what they would have been entitled to.[356] This allocation is done proportionate to their shareholdings in the capital and within the limits of their application. If there are any leftovers from the allocated shares, the general meeting shall decide how to dispose of such shares.[357]

By virtue of their inherent nature to the shareholders the law has put three exceptional situations where preemptive rights can be deprived.[358] One is where the interest of the company requires it.[359] There is no clear cut definition of what the interest of company is and how to establish it under the Ethiopian law. However, by taking inference from other civil law countries

[351] Ibid, Article 326.
[352] Ibid.
[353] Ibid, Article 470.
[354] Ibid, Article 470(2).
[355] Gebremeskel, supra note 12 at 100.
[356] Ibid, Article 471.
[357] Ibid, Article 472.
[358] Ibid, Article 473& 474.
[359] Ibid.

experiences it could be cases where the company wants to go public and requires more shareholders which mandate the relinquishment of the preemptive rights of shareholders.[360] This decision is taken by general meeting which decides on the increase of capital when it fulfills requirements of directors and auditors report.[361]

The second is, when the shares to be issued are convertible debentures. [362] When a company wants to issue convertible debentures the prior approval of an extraordinary general meeting accompanied by renunciation of shareholders preemptive rights is mandated. This requirement is coupled with the directors' report and the auditors' special report that states the reason for the issuance and time within which such conversion may be exercised and the manner of the conversion and confirmation thereof.

The third exemption is shares that issued for contributions other than cash i.e. in kind contributions.[363] The specific restriction in the law for the exercise of preemptive rights for cash contribution only can be justified for the same logic as US for accommodating the needs of the company. [364]

3.4.1.1. Fiduciary Duties

Directors are bestowed with the power to manage the affairs of the company under the law, the memorandum and article of association and resolutions passed at a meeting.[365] With these powers comes responsibility. Under the Code, Directors owe fiduciary duty to the company and

[360] Ventoruzzo, supra note 3 at 524.
[361] Com. Code. Supra 10 at aarticle 473.
[362] Ibid, article 474.
[363] Ibid, Article 345(4).
[364] Ventoruzzo, supra note 3 at 523.
[365] Ibid, Article 363.

its general management.[366] They are treated as the agent of the company in which they are held jointly and severally liable for any breach of such duties.[367] In all circumstances the Board of Directors are expected to take all the necessary steps to prevent or mitigate acts that are prejudice to the company within their knowledge. They should take all the necessary steps to prevent or mitigate acts prejudicial to the company which are within their knowledge.[368] The burden of proof for breach of such duties lies on directors to show they have exercised due diligence.[369]

All direct and indirect dealings between the company and its directors is subject to prior approval of the board of directors and it is required that notice be given to the auditors.[370] The auditors on the basis of such notice will submit a special report to the general meeting relating to the dealing approved by the board of directors. On the basis of such report decisions will be taken in the general meeting. [371] The approval given by the board will only be revoked if there is fraud. [372] In such cases, the decision taken by the board will remain effective but the director responsible will liable for damage.[373] If such director fails to pay for such damages the board of directors will be jointly and severally liable.[374]The law specifically prohibits the Directors from contracting loans with the company.[375]

Whenever directors fail on their duties the shareholders are not allowed to directly institute a suit against them rather there are steps mandated by the law to be taken prior. To enforce the

[366] Ibid, Article 364.
[367] Ibid
[368] Ibid
[369] Ibid
[370] Ibid, Article 356 Com. Code.
[371] Ibid.
[372] Ibid.
[373] Ibid.
[374] Ibid.
[375] Ibid, Article 357.

directors' liability, first, there should be a resolution of general meeting to be effected.[376] Second, in the resolution if one fifth of the shareholders representing the capital voted in favor of the proceedings against such directors, the directors shall be removed and the proceeding against her shall be instituted with three months.[377] Failure to do so will result in shareholder who voted for such proceeding to jointly institute a suit against such director.[378] No resolution or proceeding shall be adopted if it is voted against by one fifth of shareholders representing the capital.[379] Derivative suits are not practiced in the country which is deemed as one of the failures of shareholder protection in the country.[380]

3.4.2. **Contracts**

According to the Ethiopian commercial code share companies are formed through partnership agreements which are contracts.[381] The partnership agreement in share companies refers to memorandum and articles of association which determine the relationship between shareholders, the company and other participants. [382]

When we come to the role of contracts in the application of preemptive rights, the code specifically prohibits the affording of these rights in any other documents.[383] It states that "no documents conferring preemptive rights of subscription may be issued." [384] This devours the use of contracts in affording preemptive rights in Ethiopia. With regards to anti-dilution rules the

[376] Ibid, Article 365.
[377] Ibid.
[378] Ibid.
[379] Ibid.
[380] Ibid, Article 367.
[381] Gebremeskel, supra note 12 at 57.
[382] Ibid.
[383] Com. Code, supra note 10 at Article 475.
[384] Ibid.

commercial code does not make mention of it and thus, it is difficult to make any presumption on this rule.

3.4.3. **The viability of adopting preemptive rights and anti-dilution rules in light of the US in Ethiopia**

In transplanting law of any country, especially from developed to developing, different factors need to be taken into consideration.[385] These are the legal families, the socio-economic development, corporate structures and the enforcement mechanisms.[386] The US which is acclaimed for its developed economy, capital market and legal infrastructures, it is a system that creates a chain among the different bodies of the corporate law that aids in the disciplining and controlling of the system. [387] Thus, awarding preemptive rights and anti-dilution rules in opt-in basis nothing short of the right decision.

For Ethiopia, the writer believes that replicating the US law in its exact form and adopting this rules as an opt-in rule is not viable option for our socio-economic realities. Ethiopia is one of the poorest countries in the world which inhibited its development in all sectors of the economy.[388] First, one of the identifying features of share companies in Ethiopia is concentrated structure of ownership which can creates a block holding.[389] Thus, adopting the opt-in rule of a country with dispersed ownership structure is not sound. Second, in Ethiopia, there is no share market or an established regulatory organ which can facilitate trading of stocks, liquidity and integrity of the market. [390] Trading in shares is in practice done *via* offer for sale and private placements.[391] This

[385] Dam, supra note 196 at 20.
[386] Ibid.
[387]Kraakman, supra note 17 at 32.
[388] Dagnaw G. Walelgn, *Individual Bankruptcy Law for Ethiopia: Lessons from US & German*,(2014) Central European University at 51.
[389] Gebremeskel, supra note 9 at 2.
[390] Ayele, supra note 14 at 12.

impedes the valuation and determination of price of shares and the liquidity thereof.[392] When seeing this market reality of Ethiopia and adopting the law of the country with vibrant and robust capital market which disciplines and controls the stock market will bring disaster than wealth. Third, the inadequacy of shareholders protections that exist in the country due to the absence of one-share-one-vote rule which is manifested by limitations of voting in shareholders meeting placed under Article 408 of the Code and the non-existence of derivative suits is another example.

Fourth, ineffectiveness of the court system which takes a protracted time to decide even with the new BPR (Business Process Reengineering)[393] which was adopted to improve the public services delivery services is another headache.[394] Even passing this protracted nature of the court procedure, finding judges who are well groomed in company law with the ability to weigh in facts the standard systems requires in default rules from experience is highly unlikely.[395] Moreover, such procedure will be susceptible to exploitation and abuse.[396]

Last but not least, default rules rely on voluntary compliance and negotiating for the provision of such rights.[397] Owing to the lack of the culture of competition and voluntary compliance to

[391] Ibid at 82.
[392] Gebremeskel, supra note 9 at 26.
[393] BPR (Business Process reengineering) is a system adopted by the Ethiopian Government with the aim of improving the public services delivery services. Tesfaye Debela, *Business process reengineering in Ethiopian public organizations: the relationship between theory and practice*, www.ajol.info, last visited April 6, 2015
[394] Ayele, supra note 14 at 14.
[395] Ibid.
[396] Ibid.
[397] Hussein Ahmed Tura, *Reforming Corporate Governance in Ethiopia: Appraisal of Competing Approaches*, file:///C:/Users/Administrator/Downloads/107620-293637-1-PB.pdf at 177.

procedures and non-awareness of such rights, it is highly dubious such compliance and negotiation will transpire.[398]

Thus, in light of these realities instead of transplanting preemptive rights and anti-dilution rule, the writer believes that making the rules mandatory (*ex ante*) is the way to go. This gives preliminary protection to shareholders irrespective of whether they negotiated for it or not. Furthermore, it opens the door for less interpretation in cases of violation since the courts will use the standards set forth. For a civil law system country where the judges are used to interpretation of laws from statutes, this system allows the continuation of this legacy.

Another issue is the application and the type of approach to follow. In Ethiopia since preemptive rights are provided as a mandatory rule, the issue will be what type of steps need to be taken to facilitate the implementation without affecting the interest of the company. According to the Ethiopian Law for the exercise of these rights at least one month is set for the exercise of these rights. Limiting the exact date for the application of such rights to avoid conflict between shareholders and the company will be beneficial.

In determining which approach to follow in Anti-dilution rules due to the difficulty of determining the market price in the country due to the non-existence of stock markets, it is best for the corporation to rely on conversion price formulas than market price formula.[399]

[398] Ibid.
[399] Ayele, supra note 14 at 14.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

Financing through equity plays a pertinent role in the growth and development of corporations. For shareholder and investors to put their trust in the company and the country at large by infusing capital in business an effective regulatory mechanism that houses their interests while still giving corporation to perform its activities is essential. Among those regulatory mechanisms that protect the interest of shareholders and investors are preemptive rights and anti-dilution rules.

The standards and the mode of application of this rules vary among jurisdictions which is either applicable as a mandatory rule or default principle. The follower of the first is Ethiopia while the second is US. In US both preemptive rights and anti-dilution rules are the subject of "no default" rule which are only applicable if the parties opt-in in the charter of incorporation. The main safety mechanism that the system offers is fiduciary duties of shareholders and other regulatory bodies that aid in controlling and disciplining the corporate form while maintaining the capital market integrity.

Applying the same standards in Ethiopian corporate form which lags in eco-social and legal infrastructure that supports the system will be ill-fit for the country. Therefore, the provision of this rules in mandatory form and the incorporation of such laws in the now being revised Commercial Code is recommended.

In the light of this, the continuance of preemptive rights as a mandatory rule is fits the reality the country. However, determining the basis for affording of preemptive rights and the length of the time of application is essential. Furthermore, adopting anti-dilution rules so as to accommodate

the inflow of investors in the country and the creation of complex securities to entertain their interest is crucial. As to the approach to follow, since the country's reality makes valuation of market price of shares difficult, adoption of conversion-price formula makes it a viable choice in the applicability of this rule.

Lastly, it should not be forgotten that the role establishing capital markets or any market that facilitates trading of shares in the country that can discipline the market and the corporate form is vital.

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