PRIVATE EQUITY IN ETHIOPIA: EXIT CHALLENGES

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Table of Contents

Abstract

This thesis is inspired by the author's work experience on private equity deals in Ethiopia. The main questions raised by private equity funds revolves around enforcement of certain exit clauses in Ethiopia. Providing a clear-cut answer to a client is impossible in circumstances where there is a lack of legislation, case law or literature.

With the purpose of putting the spotlight on the issue, this thesis will discuss exit challenges faced by private equity funds in Ethiopia, will assess the validity of exit clauses such as tag-along and drag-along clauses in Ethiopia and will conclude with lessons from USA and UK on the issue. This is primarily done by examining the legal rules applicable to exit in Ethiopia.

This thesis has taken the view that exit clauses should be enforceable in Ethiopia as they are not contrary to mandatory statutory law and the close reading of the Commercial Code supports the validity of exit clauses.

Abbreviation and Definition

AOA	Articles of Association
BVCA	British Private Equity and Venture Capital Association
East Africa	Kenya, Tanzania, Uganda, Ethiopia, Rwanda, Somalia and Burundi
PLC	Private Limited Company
USA	United States of America
USD	United States Dollar

Introduction

Despite small and medium enterprises (SMEs) accounting for 90% of businesses worldwide, they face a constraint to grow their business in emerging markets due to the limited opportunity to access to finance.[1] Alternative financing options, which include private equity, can be a critical source of financing in emerging markets especially for innovative SMEs in places where banking and debt financing is limited, and capital markets are less developed.[2] The benefit of private equity is not limited to providing finance, however according to a report prepared for European Union's Venture Capital Association, private equity has significantly contributed to the economy of Europe by increasing "*innovation; enhancing productivity through attracting incremental investable funds; building more resilient companies and raising the operating profitability of portfolio companies; and improving competitiveness at a macroeconomic level through making funding available for risky but potentially lucrative new business opportunities and focusing portfolio companies on internationalization; as well as indirectly by contributing to the creation of new businesses."*[3] Thus, in addition to providing finance, private equity can benefit SMEs by expanding their business activities, transferring know-how as well as restructuring the target firms' governance or accounting systems.

Exiting the investee company (referred to as portfolio company) with a profit is a crucial element of the investment cycle of private equity funds. Accordingly, a private equity firm before initiating fundraising dedicated to a certain country, it will conduct a due diligence on the market and legal system of the country.[4] In relation to exit, the due diligence can include information on available exit strategies or routine, which range from initial public offering to private share transfer, and enforcement of exit clauses such as first refusal right, tag-along or drag-along rights. This is of

[1] The World Bank, 'Improving SMEs' Access to Finance and Finding Innovative Solutions to Unlock Sources of Capital', <https://www.worldbank.org/en/topic/smefinance> accessed 12 May 2020.

[2] International Finance Cooperation (IFC), ' Fostering Development Through Private Equity' *IFC* (May 2016) <https://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/news/fostering+development+through+private+equity> accessed 30 March 2020.

[3] Frontier Economics, 'Exploring the Impact of Private Equity on Economic Growth in Europe' (London, May 2013) 10.

[4] Alexander Groh, Heinrich Liechtenstein, Karsten Lieser and Markus Biesinger, 'The Venture Capital and Private Equity Country Attractiveness Index 2018' (ninth Edition, 5 February 2018) 7 <https://blog.iese.edu/vcpeindex/files/2018/02/report2018.pdf> accessed 12 April 2020.

crucial importance because if the outcome shows uncertainty in relation to enforcement of claims, investors will refuse to allocate capital in that country.[5]

As of 2019, Ethiopia ranks 114 out of 141 countries in terms of the extent SMEs can access finance they need for their business operation through the financial sector and in terms of availability of domestic credit to private sector % GDP[6] Ethiopia ranks 103.[7] Furthermore, the lack of access to financing has been indicated as the second most problematic factor in doing business in Ethiopia.[8] The country's private sector can use the financing that will be provided by private equity to finance its business. Private equity investment in Ethiopia is a recent development. SGI Frontier Capital (previously Schulze Global Investments Limited) is the first private equity firm which invested in Ethiopia's SMEs sector through its Schulze Global Ethiopia Growth and Transformation Fund in 2015.[9] To benefit from the finance that can be made available by private equity, Ethiopia, among other things, needs enabling legal environment.

In Ethiopia the lack of legislative regulation on the issue of exit coupled with underdeveloped capital market creates uncertainty for private equity funds as to available exit strategies and/or enforcement of exit clauses. Accordingly, the issues surrounding exit remain to be uncertain in Ethiopia. However, as more private equity funds prepare to exit, the practicability of exit strategies and enforcement of exit clauses will become clearer. The involvement of courts in the enforcement of exit rights might be unavoidable as well.

Against this background, the purpose of this thesis is to navigate the challenges private equity funds might face during exit in Ethiopia with special focus on whether and which exit rights clauses are enforceable in Ethiopia and the possible challenges that might be raised against their

[5] ibid 10.
[6] Domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. The World Bank, 'Domestic Credit to Private Sector (% of GDP)' <https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS> accessed 12 May 2020.
[7] World Economic Forum, 'The Global Competitiveness Report 2019' <http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf> accessed 12 May 2020.
[8] World Economic Forum, ' The Global Competitiveness Report 2016-2017' <http://reports.weforum.org/africa-competitiveness-report-2017/files/2017/05/Ethiopia.pdf> accessed 12 May 2020.
[9] CDC Investment Works, 'SGI Ethiopia Growth and Transformation Fund' < https://www.cdcgroup.com/en/our-investments/fund/sgi-ethiopia-growth-and-transformation-fund/> accessed 12 April 2020.

enforcement. By taking the experience of other jurisdictions, the paper will highlight the aspects of exit clauses that could turn out to be contentious.

Methodology

This research will be conducted by using both primary and secondary sources. Books, journal articles, template transaction documents suggested by private equity associations and other electronic sources will be used as a secondary source. The main challenges the author faced are the lack of materials written on Ethiopian company law and the limited access to Ethiopian court cases as only cases which have reached the Cassation Bench of the Federal Supreme Court on the ground of error of law are published and hence the discussion in this thesis is limited to the few published cases.

As companies limited by shares are the most dominant business forms in Ethiopia, this thesis is limited to dealing with the enforcement of exit clauses in a PLC, which resembles to closed corporation in the USA, and share company which resembles to corporations in the USA. Cases from the United Kingdom (UK) and the USA has been used in this thesis because USA and UK have been ranked as the top two attractive countries for private equity investment for consecutive years[10] and English common law is the most widespread legal system in the world.[11]

Road Map of the Thesis

This thesis will have three chapters. The first chapter will be overview of private equity funds. This chapter will introduce the basic essence and structure of private equity investment in order to show why exit from the portfolio company is a crucial element for private equity funds. The second chapter will deal with the regulation of private equity investment in Ethiopia with a special focus on exit. The purpose of this chapter is to highlight and show how different regulatory laws impact private equity exit in Ethiopia. The third chapter will deal with exit strategies and the validity and enforceability of exit clauses under Ethiopian law. The focus of this chapter will be assessing the

[10] Alexander Groh, Heinrich Liechtenstein, Karsten Lieser and Markus Biesinger, 'The Venture Capital and Private Equity Country Attractiveness Index 2018' < https://blog.iese.edu/vcpeindex/ranking/> accessed 12 April 2020.
[11] Sweet and Maxwell, 'Press Releases on Philip Wood's Book Tilted Maps of World Financial Law' (27 November 2008)<https://www.sweetandmaxwell.co.uk/about-us/press-releases/061108.pdf> accessed 12 April 2020.

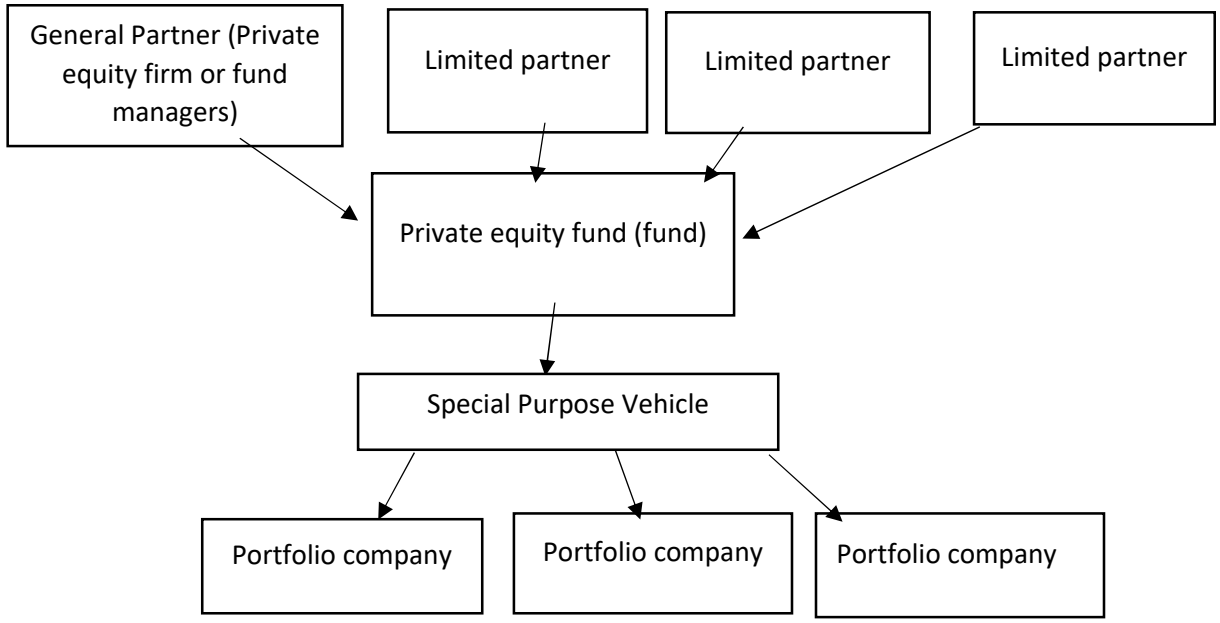
provisions of the Ethiopian Commercial Code, which governs business organizations, in order to assess the validity of exit clauses. The last part of the thesis is dedicated to conclusion.

Chapter One: General Introduction to Private Equity

1.1. Definition and Structure of Private Equity Investment

Private equity refers to an alternative financing form or an investment in private companies, which is typically made by private equity funds, which are separate judicial persons formed to limit liability exposure.[12] A private equity fund (fund) is an actively managed collective investment vehicle which invests in private, unlisted companies (portfolio company) or in publicly traded equity securities, where the portfolio company is then immediately taken private.[13] The fund through wholly owned separate judicial person (referred to as special purpose vehicle (SPV)), in most instances, secures an equity or quasi-equity stake (minority or majority) in the portfolio company in return for the investment it made.[14] The main purpose of using SPV is to limit the fund's liability exposure.

A typical private equity investment will have the following structure:



[12] Claudia Sommer, *Private Equity Investments Drivers and Performance Implications of Investment Cycles* (Springer Gabler 2012)14.
[13] Jennifer Payne, 'Private Equity and Its Regulation in Europe' (2011) 12 EBRO 562.
[14] East African Venture Capital Association, Financial Sector Development Africa and International Finance Corporation, 'Private Equity Investment Guide: For Limited Partners in East Africa' (2019) 9.

Accordingly, in private equity investment there are at least three separately incorporated judicial persons i.e. the private equity fund, the SPV and the portfolio company.

1.1.1. **Private equity fund:** The fund vehicle itself is normally set up as a limited partnership or trust, but in certain countries a limited liability company is used.[15] The most common structure is limited partnership.[16] The limited partnership will have a limited partner(s) and a general partner. The investors in a limited partnership structure are referred to as limited partners, while the investment manager or the private equity firm is referred to as the general partner.[17] The limited partners will subscribe 99% of the funds capital whereas the 1% is held by general partners.[18] The limited partnership agreement is the key legal document, which governs how the fund shall be run, and the relationship between the limited partner and the general partner.[19]

The private equity fund should be domiciled in a reputable jurisdiction. A key determinant in the selection of the appropriate domicile is the applicable tax regime that would affect the investors and its ability to afford them limitation of their liability.[20] International investors and/or development finance institutions (DFIs) prefer those jurisdictions that offer such investors a tax regime that is not considered by the DFIs to constitute "harmful tax practices".[21] In relation to private equity funds, which invest in Africa, the common jurisdictions used in the establishment of private equity funds include Mauritius, the Cayman Islands, Guernsey, Luxembourg and South Africa.[22]

1.1.2. **Limited partners:** The limited partners are responsible for contributing most of the fund's asset and enjoy immunity from liability beyond the amount contributed.[23] The limited partner usually consist of high net worth individuals and families, pension funds,

[15] ibid 17.
[16] ibid.
[17] ibid.
[18] Sommer(n12)18.
[19] Private Equity Investment Guide (n14) 18.
[20] ibid 22.
[21] ibid 22.
[22] ibid.
[23] Payne (n13) 563.

endowments, sovereign wealth funds, banks and insurance companies.[24] The asset held by the limited partners is their stake in the private equity fund. The general partner will have unlimited liability and will act as the management of the private limited partnership(fund).[25]

1.1.3. **General Partner:** The general partner also known as private equity firm performs the fund management duties, and seek and screens investments, conducts due diligence and prepares investment proposals to the investment committee.[26] Private equity firm, which will act as an intermediary between the fund investors and the portfolio company is engaged starting from sourcing deals to managing the investment in the portfolio company.[27]

The general partner's return is primarily generated from its fees.[28] The general partner will charge a management fee, and will also take a share of the funds profits if the investment performs well.[29] This share in the funds profit is known as "carried interest" that usually consists of 20% of realized gains from investments.[30] The carried interest will be calculated on the amount that is left after the limited partners received their initial fund commitment plus a 'hurdle', a minimum return the limited partners expect from their investment, which could range from 6 and 8 per cent year.[31]

1.1.4. **Committees:** a private equity fund can have an investment committee or limited partners advisory committee. The investment committee includes members of the fund manager's team as well as external experienced investment professionals, and its main task is to approve deals. The limited partners advisory committee (LPAC) is typically responsible

[24] ibid 564.
[25] Andrew Wylie and Nathaniel Marrs, 'English and US private equity funds: Key Features' (*Thomas Reuters* 2018) <https://uk.practicallaw.thomsonreuters.com/w-016-1407?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 7 April 2020.
[26] Private Equity Investment Guide(n4)17.
[27] Sommer(n12)16.
[28] Payne (n13) 562.
[29] Stephanie Biggs, 'Private Equity: A Practical Guide' (2008) 8(4) Legal Information Management' 248.
[30] Sommer(n12)18.
[31] Josep Duran and Oscar Farres, 'Venture Capital Private Equity and Corporate Venture Capital' in Luisan Alemany and Job J. Andreoli (eds), *Entrepreneurial Finance: The Art and Science of Growing Ventures* (Cambridge University Press 2018) 118.

for making sure the governance aspects of the fund are adhered to and no conflicts of interest occur.[32] The LPAC's main task is to express the views of limited partners within the private equity fund. Investors do not form part of the investment decision-making or fund management but may be appointed to LPAC. However, they will expect to receive regular and detailed update from the general partner on the investment made by the fund.[33]

Against the above background the next section will deal with private equity investment cycle with the aim of explaining the process that is involved from fund raising to liquidating the fund.

1.2. **Private Equity Investment Cycle**

Private equity funds are typically raised with an expected life of around ten to twelve years.[34] This period can be divided into two general periods, (I) securing investors/formation period, which consists of fund raising and closing of the fund, and (II) the investment period, which consists of making investment in the portfolio company and disposing that investment(holding period) and liquidating the fund.

Typically, the fund manager will raise a fund to provide the money for making investments. This period consists of promoting the fund, recruiting potential investors and making investors to make commitment. This commitment is legally binding; the investor is obliged to provide the amount committed, as and when the fund manager calls for cash to fund investments for the fund.[35] The formation period might take longer or shorter period depending on the reputation of the fund manager.

In the investment period, the fund manager must source transactions, make investments, grow those companies over the holding period of three to five years and exit with profit.[36] During the investment period, the private equity firms can deploy capital from the fund to make different investments in different portfolio companies.[37] The main purpose of the private equity fund is to

[32] Private Equity Investment Guide(n4) 26.
[33] Payne (n13)563.
[34] Private Equity Investment Guide(n4) 19.
[35] ibid.
[36] Stephanie Biggs of Kirkland & Ellis International LLP (n29) 248.
[37] Private Equity Investment Guide (n4)19.

provide profit for its investors over the life of the fund. Thus, during its investment the main focus of the private equity is on capital appreciation, rather than income generation, and managing these investments to maximize their value on disposal or exit.[38]

Even if the investment cycle is similar private equity funds can take specialized approach by targeting specific sectors, geographical area or portfolio company stage of development. The next section will deal with types of private equity funds based on the growth stage of portfolio company they target.

1.3. **Types of Private Equity Funds**

Private equity, depending on the development of the market and its focus, encompasses a variety of investment strategies or fund types including venture capital, growth capital, distressed opportunities and leveraged buy-out.[39] A brief sketching of these, as tokens for understanding the functioning of private equity, is therefore inevitable.

First, venture capital funds target relatively unproven business models with potential for steep growth on uptake in the market.[40] The targets of venture capital funds are mainly technology or science driven businesses with an innovative or disruptive service or product.[41] The level of risk the venture capital carries is much higher due to the unproven status of the portfolio company's product in the market. Venture capital funds usually acquire a minority equity in the portfolio company.[42]

Second, growth capital and development capital is another strategy of private equity that contains an investment in relatively mature companies, which require funds for future growth and expansion. It is investment in business that have gone past an initial venture or start-up capital phase, but that are still relatively small.[43]

[38] Wylie and Marrs (n25).
[39] Private Equity Investment Guide (n4)10.
[40] ibid.
[41] Duran and Farres (31)100.
[42] Sommer (n12)18.
[43] Geoff Yates & Mike Hinchliffe, A *Practical Guide to Private Equity Transactions* (Cambridge University Press 2010)5.

Last but not list, leveraged buyouts is an investment mechanism where a mix of equity and significant debt is utilized by the private equity firm in order to fund the acquisition of the portfolio company.[44] Thus, the private equity will use a small amount of its funds as equity and leverage a large percentage of the transaction with bank loans or subordinated debt.[45]

Conclusion

As can be seen from the above discussion, a private equity fund invests with the intended purpose of exiting the portfolio company with profit. Thus, having a legal system and market that will enable the smooth exit of private equity funds will be crucial to attract private equity investment.

[44] ibid 3.

[45] Duran and Farres (31)102.

Chapter Two: Ethiopia's Private Equity Industry

Based on the survey conducted by the African Venture Capital Association with the participation of limited partners from across the globe and general partners engaged in African private equity, Ethiopia is considered to be the third most attractive country for private equity investment in Africa over the next three years.[46] Private equity deals in Ethiopia have shown increase both in number and deal value over the past few years and six deals have been reported in the year 2019.[47] However, Ethiopia's share in the number and value of private equity deals in East Africa is merely 9%.[48] This is significantly lower compared to its neighbor Kenya, which attracts around 54% of East Africa's private equity deals by volume and by value.[49] This is despite the fact that Ethiopia has double the total land area and population of Kenya.[50] One of the explanations for this difference can be the level of private sector development in these countries. In the past two years, Ethiopia is relaxing its public sector-led economic growth through reforms which will increase the participation of the private sector investment in the economy.[51] The reform includes privatization of enterprises and opening up of some sectors of the economy, which used to be reserved for the government owned enterprises or domestic investors.[52]

This chapter deals with Ethiopia's existent regulatory framework applicable to private equity investments with a special focus on legislations impacting exit.

[46] African private Equity and Venture Capital Association (AVCA), 'African Private Equity Industry Survey' (March 2020)21.

[47] '6 Ethiopian Private Equity and VC Deals in 2019' *African Private Equity News* (3 January 2020) <https://www.africaprivateequitynews.com/app-post-details/?post_id=19752> accessed 27 March 2020.

[48] AVCA (n45)12.

[49] ibid.

[50] In accordance with World Bank data Ethiopia with the total land area of 1,000,000km^2 is the second populous nation in Africa after Nigeria with an estimated 110 million population. Whereas Kenya covers a total land area of 580, 367km^2 with an estimated population of 51.39 million. <https://data.worldbank.org/country/ethiopia> and <https://data.worldbank.org/indicator/SP.POP.TOTL>.

[51] International Finance Cooperation, 'Country Private Sector Diagnostic: Creating Markets in Ethiopia' (2019) ix <https://www.ifc.org/wps/wcm/connect/publications_ext_content/ifc_external_publication_site/publications_listing_page/cpsd-ethiopia> accessed 10 May 2020.

[52] ibid.

2.1. Ethiopia's Private Equity Investment Landscape

Currently, there is no locally raised private equity fund due to the lack of enabling legislation. The Banking Business Proclamation provides the closest definition to the activity of private equity funds as banking business, '*receiving funds from the public and using the funds in whole or in part, for the account and at the risk of the person undertaking banking business, for […] investments acceptable by the National Bank'*. [53] This definition targets investments to be made by banks rather than by a non-banking financial institution, which raises funds for the sole purpose of making investment in other companies. By noting this gap in the law, the government has announced its plan to develop a policy framework, which will enable setting up of a local private equity fund in the country.[54]

All private equity funds or firms that have invested in Ethiopia are incorporated abroad and some have opened a commercial representative office[55] in Ethiopia to oversee their investment in the portfolio companies.[56] The agriculture business and consumer goods sector each attract 40% of the total private equity investment in Ethiopia followed by telecommunication, media & technology at 20%.[57] The private equity funds investment in the portfolio companies ranges from USD 200,000 to 50 million.[58]

[53] Banking Business Proclamation No.592/2008, *Federal Negarit Gazeta*, 14th Year No. 57, 25 August 2008, art 2(2(a&b)).

[54] Brook Abdu 'Venture Capital Policy on the Horizon' *The Reporter* (Addis Ababa, 15 June 2019) <https://www.thereporterethiopia.com/article/venture-capital-policy-horizon> accessed 1 April 2020.

[55] As per Article 33(4) of Commercial Registration and Licensing Proclamation No. 980/2016, a commercial representative office (CRO) *is an entity that can only engage in promotion and market survey and trade expansion to enable the parent company to invest in Ethiopia. CRO cannot engage into supply of goods or service or enter into contracts with clients.*

[56] Precise Consult International PLC, 'Mapping Financial Services available for food, dairy, and feed processors operating in Ethiopia' (2017) 15.

[57] Asoko Insight, 'Ethiopia's Private Equity Landscape' (8 June 2019) <https://asokoinsight.com/content/quick-insights/ethiopia-private-equity-landspace> accessed 1 April 2020.

[58] Ibid.

2.2. Overview of Ethiopian legislation applicable to Private Equity Exit

The investment of private equity funds, especially exit, is subject to different regulatory regimes. The below section will deal with legislations that will be applicable to private equity investment with a special focus on exit.

1. **Investment Law**: The Investment Proclamation governs investments made by an enterprise incorporated outside of Ethiopia or an Ethiopian incorporated enterprise with a foreign national shareholder (foreign investors)[59]. The investment law provides list of sectors a foreign investor cannot invest in, minimum capital and documentary requirements during establishment, and guarantees against expropriation and nationalization. Most importantly, it guarantees foreign investors the right to remit their earnings, which includes profits and dividends, proceeds from the transfer of shares and proceeds from the sale or liquidation of an enterprise, out of Ethiopia in a convertible foreign currency.[60]

2. **Tax Law**: If the private equity obtains dividend during the investment period, the income will be subject to a dividend tax at a rate of 10%.[61] The private equity can advance loan to the portfolio company in the form of shareholder loan and if an interest is charged, then it will be subject to tax at a rate of 10%.[62] In relation to exit, a share or asset transfer triggers capital gains tax. The capital gains tax on share transfer is 30% and will be levied if the shares are being transferred above their par value.[63] Whereas, the capital gains tax rate for asset transfer is 15%.[64]

3. **Commercial Code**: This governs business organizations and the rights and obligations of shareholders. The Commercial Code has been in place since 1960 without amendment. Further, in the year between 1974 to 1991, the country was under the ruling of a socialist government, which nationalized medium and large-scale enterprises and kept the involvement

[59] Investment Proclamation No.1180/2020, *Federal Negarit Gazeta*, 26th year No.28, 2 April 2020, art 2 and 4.
[60] ibid art 20.
[61] Federal Income Tax Proclamation No.979/2016, *Federal Negarit Gazeta Extraordinary Issue,* 22nd year No.104, 18 August 2016, art 55.
[62] ibid art 56.
[63] ibid art 59.
[64] ibid.

of the private sector to micro and to small activities.[65] This restriction in trade hindered the development of the Commercial Code through practice.

In general, business organizations in Ethiopia are divided into two (1) partnerships, which is sub-divided into general partnership, ordinary partnership and limited liability partnership, and (2) companies limited by share, which is further divided into share company and PLC. The most popular type of business organization is companies limited by share. The main differences between a share company and a PLC that a private equity fund needs to note are the following:

- **Minimum Number of Shareholders:** a share company needs a minimum of 5 shareholders[66] whereas a PLC can have 2 to 50 shareholders[67].
- **Capital Structure:** the capital of a share company can be structured into paid and subscribed portions.[68] Whereas, the capital of a PLC must be paid up.[69]
- **Share Transfer Restrictions:** In a share company shares are freely transferable. Whereas, in PLC transfer of shares to third parties requires the approval of the majority of members representing at least 75% of the capital[70].
- **Requirement of Board of Directors (BOD):** a share company is required to have a BOD with 3 to 12 members who are responsible for the management of the company.[71] All members of the BOD have to be shareholders of the company. A PLC is not required to have a BOD.
- **Preference Shares:** a share company can issue preference shares carrying preferred right of subscription in the event of future issues, or rights of priority over profits, or assets or both.[72] However, PLCs cannot issue preferential shares.

[65] Organization for Economic Co-operation and Development, 'The Ethiopia Trade and Transformation: Diagnostic Trade Integration Study' (vol 2 ,2004) 12 < https://www.oecd.org/aidfortrade/countryprofiles/dtis/Ethiopia-DTIS-2004.pdf> accesses 1 May 2020.
[66] Commercial Code of the Empire of Ethiopia Proclamation No.166/1960, *Negarit Gazeta*, 19th year No.3, 5 May 1960, art 307(1).
[67] ibid art 510(2).
[68] ibid art 313(1).
[69] ibid art 517.
[70] ibid art 523(2).
[71] ibid art 347.
[72] ibid art 336.

- **Calling of a meeting by shareholders:** Shareholders representing at least 20% of the capital of a share company can call a meeting or shareholders which control 10% of the capital can request the court to call a meeting. In relation to PLCs, shareholders who hold 50% of the capital of the PLC can call a meeting[73].
- **Meetings:** a share company is required to conduct an annual general meeting within four to six months from the end of each financial year.[74] PLCs having less than 20 members are not required to hold a regular annual general meeting[75]. Thus, decisions in a PLC with less than twenty members can be made informally without the need to have regular meetings.

Share companies can easily raise finance, compared to PLC, by issuing shares whose value does not have to be paid at once and by also issuing preference shares, which will confer the holder special rights. From the perspective of private equity exit, it is easy to exit a share company as shares are freely transferable and unlike PLC the approval of shareholders who hold more than 75% of the capital of the company is not required. Further, in terms of governance a share company is more transparent as annual meetings are mandatory and minority shareholders who hold 20% of the capital of the company can request shareholders meeting other than the annual meeting. However, this threshold increases to 50% in PLC's.

4. **Competition regime:** Transactions which are defined as merger are required to be approved by the Trade Competition and Consumer Protection Authority (TCCPA) before taking effect.[76] Only merger transactions whose value is less than Ethiopian Birr 30,000,000 (~USD 89,128[77]) are exempted from giving merger approval notification to TCCPA.[78] The Trade Competition and Consumer Protection Proclamation (TCCPP) defines merger in broad terms to include:

> *When two or more business organizations previously having independent existence amalgamate or when such business organizations pool the whole or part of their resources*

[73] ibid art 532(2).
[74] ibid art 418.
[75] ibid art 532(1).
[76] Trade Competition and Consumer Protection Proclamation No.813/2013(TCCPP), *Federal Negarit Gazeta,* 20th year No.28, *21 March 2014,* art 10(1).
[77] As of 12 May 2020, 1 USD= 33.6594 ETB <https://www.xe.com/currencyconverter/convert/?Amount=3%2C000%2C000&From=ETB&To=USD>
[78] The Ethiopia Trade Competition and Consumer Protection Authority Merger Notification Directive, 2016.

for the purpose of carrying on a certain commercial activity; or by directly or indirectly acquiring shares, securities or assets of a business organization or taking control of the management of the business of another person by a person or group of persons through purchase or any other means.[79]

The TCCPP applies to merger transactions, which took place in Ethiopia or having an effect in Ethiopia.[80] The TCCPP or TCCPA does not provide a guideline as to when a transaction would qualify as to having an effect in Ethiopia. In practice, whether a transaction has an effect or not depends on the discretion of TCCPA. This creates uncertainty as parties to an offshore transaction which are not certain about the effect of a merger transaction in Ethiopia must submit application for TCCPA to examine and give them a greenlight to proceed with the transaction. Accordingly, private equity funds who intend to exit the Ethiopian market through transaction that will take place outside of Ethiopia have to take into consideration the merger notification requirement under the TCCPP.

5. **Foreign Exchange Regulation:** a private equity fund must register the investment it makes in a foreign exchange either in the form of equity or shareholders loan at the National Bank of Ethiopia.[81] This registration certificate will be required when the private equity requests to repatriate its divided, proceed from the sale of shares or assets or the principal shareholder loan or its interest.

   As per the Global Competitiveness Index, foreign currency regulation is one of the top three most problematic factors for doing business in Ethiopia.[82] The shortage of foreign exchange is one of the main challenges for business in Ethiopia[83] and the effect has been felt by companies in recent years as some business are forced to cease operation due to the long waiting period to access foreign exchange.[84] This can impact private equity exit in terms of

[79] TCCPP (n 76) art 9.
[80] ibid art 4(1).
[81] Investment Proclamation (n 59) art 9(5).
[82] World Economic Forum (n 8).
[83] International Monetary Fund, 'IMF Executive Board Concludes 2019 Article IV Consultation with the Federal Democratic Republic of Ethiopia' IMF (28 January 2020) <https://www.imf.org/en/News/Articles/2020/01/28/pr2019-ethiopia-imf-executive-board-concludes-2019-article-iv-consultation> accessed 12 May 2020.
[84] The Economist, ' Hard Currency availability and debt sustainability in Ethiopia, Kenya, Nigeria, Tanzania and Zambia' (2019) 11 <https://pages.eiu.com/April-CDC-Asia-MKT_Report-landing-page.html> accessed 20 May 2020.

finding potential purchaser in a market which exhibits foreign currency shortage and during repatriate of proceeds from the sale of its shares, the private equity fund might be required to wait in line until foreign currency becomes available.

Conclusion

Currently, Ethiopia accounts for few private equity deals in Africa and specifically in Eastern Africa. If the country is able to realize its potential as an attractive private equity investment destination, then private equity investment can play a crucial role in easing the lack of access to finance faced by business. As discussed above, one of the key challenges for private equity funds in Ethiopia is the shortage of foreign exchange. In order to easy the problem the government must implement policy changes.

Chapter Three: Legality and Enforcement of Exit Clauses in Ethiopia

Exit is an essential part of private equity investment cycle; as discussed under Chapter one, the fund manager is investing the money of investors with a promise of returning it with profit in few years. Thus, before investing in the portfolio company, a private equity will assess whether there will be a sale opportunity for the investment.[85] To achieve profit during exit, a private equity implements different strategies that will help grow the value of the portfolio company, which includes further expansion of the business, the launch of new products or services, rationalizing parts of the cost base and/ or splitting up and dividing the business.[86]

Both limited partners and general partners who operate in Africa have raised some challenges that will impact their future investment and one of these is limited exit opportunities.[87] Exit opportunities can be impacted by different circumstances ranging from political stability to legal system of a country. This creates a risk for private equity funds as they might struggle to receive a fair market value for the investment stake during exit.[88] In order for a country to attract and benefit from private equity investments, it has to address the legal issues that impact private equity investment, one of them is private equity exit.

In the case of Ethiopia, one of the key legal issues surrounding exit is the legality and enforceability of exit clauses like tag-along and drag-along. There have not been many exits by a private equity in Ethiopia. As of now, the only reported exit in Ethiopia is the sale of Afriflora by KKR & Co. to Sun European Partners LLP in 2017.[89] This exit is insufficient to reach a more general conclusion about the enforceability of exit clause as KKR & Co. was the majority owner of the portfolio company. Furthermore, the lack of cases on transfer of shares in general and exit clauses in particular makes the issues related to exit in Ethiopia to remain uncertain and unclear. As more funds reach the final year of their investment period, we will be able to assess the challenges private equity funds might face while trying to implement their exit strategy or enforce exit clauses. For

[85] Yates and Hinchliffe (n 43) 361.
[86] ibid.
[87] AVCA (n46) 29.
[88] Armin Schwienbacher, 'Venture Capital Exits' in Douglas Cumming (eds), Venture *Capital: Investment Strategies, Structures, and Policies* (Wiley/Blackwell 2012) 15.
[89] Imani Moise 'KKR Exits African Investment: Sun European to buy Ethiopia-based Afriflora from KKR for an undisclosed amount' *WSJ PRO Private equity* (20 December 2017) <https://www.wsj.com/articles/kkr-exits-african-investment-1513774577> accessed 27 March 2020.

these reasons, this chapter deals with selected exit clauses that have been included in private equity deals in Ethiopia. More specifically, it focuses on the challenges that can be faced during enforcement of exit clauses in Ethiopia. The author will use cases decided by USA and UK courts to shed some light on the controversial issues related to these clauses and to indicate some of the precautions that needs to be taken while drafting.

3.1. Private Equity Exit Strategies in Ethiopia

In order to have a smooth exit, the private equity will prepare an exit strategy before investing in the portfolio company. Depending on how developed the market and the legal system is, the exit options can range from initial public offering (IPO), buy-back or redemption of shares, private sale of shares to a financial buyer or to another private equity investor, or strategic sale.[90]

3.1.1. Initial Public Offering: this method refers to listing the shares of the portfolio company on the stock market for the first time.[91] If the IPO is undertaken successfully it will enable the private equity to sell its shares to the public and exit.[92] Ethiopia does not have a stock exchange or a developed capital markets to publicly sell shares or to assess the value of shares as of yet; thus, IPO cannot be taken as an exit strategy by private equity funds in Ethiopia. Further, in other countries, shares of companies that are not big enough to be listed on the stock exchange are traded through over the counter (OTC) markets. OTC market refers to the market for securities that are not traded on an organized exchange and OTC trading occurs through telephone or computer negotiation between buyers and sellers.[93] This venue of trading is not currently being practiced in Ethiopia. However, few websites provide information about available shares to purchase.[94] The main role of the websites is to provide information similar to TV/Radio promotion and almost all shares, which are being promoted as available, belong to banks.

[90] Didier Folus and Emmanuel Boutron, 'Exit Stategies in Private Equity' in H.Kent Baker, Grey Filbeck, and Halil Kiymaz (eds) Private Equity: Opportunities and Risks (Oxford Scholarship Online 2015) 215.
[91] ibid 221.
[92] Armin Schwienbacher (n 88) 7.
[93] Bryan A. Garner, *Black's Law Dictionary*, (9th ed., 2006) 1214.
[94] https://engocha.com and http://myaksion.com/ are main examples of websites which promote available shares for purchase.

It is worth noting that the government of Ethiopia has a plan to set up a stock exchange by 2020.[95] There is no public information on the progress the government is making in order to achieve this plan either by setting up regulatory organs or drafting enabling policy or binding legislation. If the plan of the government materializes, in the future private equity funds can consider IPO or merging with a listed company as a possible exit strategy.

3.1.2. Buy-Back or Redemption: this is a method in which a portfolio company will repurchase its own shares from the private equity fund.[96] Under the Commercial Code the option of redemption of shares by both a share company and PLC is allowed provided that certain conditions are fulfilled.

Redemption of shares by PLCs is provided in the section of the Commercial Code, which regulates grounds of dissolution of a PLC. It states that shareholders of a PLC can include a provision in the AOA permitting a redemption of shareholders' shares for a fixed sum.[97] As repurchasing of its own share by a PLC is not dealt under the other sections of the Commercial Code, it will raise a questions whether redemption is one mechanism of dissolution for a PLC or a method to prevent the dissolution of a PLC requested by one or by a couple of shareholders.

A share company can buy-back its own shares if it is approved by shareholders meeting, the purchase price is made from the net profits and the shares are fully paid.[98] A redemption can also take place if the AOA reserve a pre-emption right to the company when a shareholder intends to transfer its share.[99] Furthermore, shareholders who dissent from resolutions concerning any change in the object or nature of the company can oblige the company to redeem their share.[100]The provisions of the Commercial Code in relation to the option of buy-back or redemption by a share company are clear compared to the provisions governing PLCs.

Accordingly, buy-back or redemption can be used as an exit strategy by private equity funds. However, the author has not come across redemption right being incorporated under AOA nor

[95] Muluken Yewondwossen 'Stock Market to Start in May' *Capital News* (Addis Ababa 30 December 2019) <https://www.capitalethiopia.com/featured/stock-market-to-start-in-may/> accessed 30 March 2020.
[96] Folus and Boutron (n 90) 220.
[97] Commercial Code (n 69) art 542(2).
[98] ibid art 332(1).
[99] ibid art 333(2).
[100] ibid art 463(1).

being implemented in practice. Due to lack of precedent, private equity funds who intend to exit through buy-back or redemption might face challenges from the regulatory authorities which might delay the exit process.

3.1.3. Private Sale of Shares: Exiting through private sale of shares is the main option for private equity funds in Ethiopia. This can be implemented by selling the shares of the SPV, that is incorporated outside of Ethiopia by the private equity fund to only own the shares of the portfolio company[101], or by directly transferring the shares it owns in the portfolio company. Both strategies will be subject to the Ethiopian tax and competition regime.

Shares are freely transferable in a share company i.e. shareholders can freely transfer their shares to third parties unless a pre-emption right is reserved to the company or to the shareholders under the AOA of the company.[102] Even pre-emption right provisions or transfer of shares restriction are required not to hinder or cause serious damage to a shareholder who may wish to assign his shares.[103] Accordingly, the Commercial Code goes to a great extent to protect the right of shareholders in a share company to freely transfer their shares.

In relation to PLCs, a share transfer to a third party has to be approved by shareholders representing at least three-quarters of the capital of the company.[104] This requirement under the Commercial Code is burdensome for a private equity that does not hold 75% or more of the shares of the portfolio company. Based on the author's experience working on private equity deals in Ethiopia, the private equity usually does not hold 75% majority in the portfolio company. This triggers a question as to what would happen if a 75% majority approval is not achieved when the private equity intends to exit the portfolio company. The Commercial Code is silent on this issue. The power of the court to force the majority shareholders who are blocking the share transfer for no good reason to approve the share transfer is questionable as it is shareholders' right to vote as they please[105]. In order to solve this issue, the author believes that the AOA by obliging the majority shareholder to approve a share transfer without unreasonable delay or hinderance can open the door for the court to review the majority shareholder's decision.

[101] *Black's Law Dictionary* (n 93) 1526.
[102] Commercial Code (n 69) art 333(2).
[103] ibid art 333(3).
[104] ibid art 523 (2).
[105] ibid art 410.

Furthermore, if shareholders are unable to reach an agreement on the approval of the share transfer, the private equity as a last resort can request dissolution of the PLC. This is costly, in terms of time and money, but a possible exit routine as shareholders of a PLC have the right to request for dissolution if serious disagreement exists between the shareholders[106] or if the term of the PLC is not fixed[107]. The dissolution of a company will take an estimated period of one year as the approval of different regulatory authorities is required. The process involves obtaining court decision for dissolution; appointment of liquidator[108]; appointment of external auditor and preparing the financial report of the company; publishing three notices with the interval of one month each in the newspaper about the proposed liquidation; comprehensive audit by Ministry of Revenue and obtaining tax clearance; cancellation of the business registration from the commercial register[109]; and applying to the National Bank of Ethiopia to repatriate profit.

3.2. Exit Right Clauses

Private equity and venture capital associations around the world provide industry-standard model transaction documents that are recommended to private equity. The model transaction documents recommended by BVCA include clauses known as exit right clauses like tag-along right, drag-along right or pre-emptive right. Whereas, the National Venture Capital Association of America includes tag-along (co-sale) and right of first refusal in the template transaction documents but not drag-along rights. This difference might be because in the United States business organizations' corporate governance is governed by state laws and in many states the enforceability of drag-along rights is uncertain apart from Delaware[110]. The Delaware Corporate Code recognizes drag-along clauses as it states:

> *A restriction on the transfer or registration of transfer of securities of a corporation or on the amount of such securities that may be owned by any person or group of persons is permitted if it: Obligates the holder of the restricted securities to sell or transfer an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, or causes or*

[106] ibid art 218(2).
[107] ibid art 542(1).
[108] ibid art 218(2) and 496.
[109] ibid art 226.
[110] Wullf A.Kaal, 'Shareholders Agreement in United States of America' in Mock, Sebastian, Csach, Kristian, Havel, Bohumil (eds), *International Handbook on Shareholders´ Agreements: Regulation, Practice and Comparative Analysis'* (Walter de Gruyter GmbH 2018) 657.

results in the automatic sale or transfer of an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing.[111]

3.2.1. Tag-along rights (co-sale): is a right for a minority shareholder to tag along with exit by the majority shareholder and sale its shares .[112] It is a mechanism to ensure that if one investor or founder has an opportunity to sell shares the other shareholders are also give that opportunity on a proportional basis.[113] A shareholder who holds this right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. [114] A template tag-along clause will be as follows:

*No transfer of Shares shall be made or registered if the same would result in a person or persons acting in concert (the **Purchasing Group**) holding or increasing their shareholding in the Company to [ ]% or more of the issued share capital of the Company unless before the transfer is made or registered, the Purchasing Group has made [or procured to be made] a written offer to all the other Shareholders (the **Minority Shareholders**) to purchase [all / the Minority Shareholders' Shareholding Percentage] the Shares in issue (the **Tag Notice**). The Tag notice shall specify the number of Shares desired to be transferred, the name of the Purchasing Group and the consideration per Share agreed with the Purchasing Group, including all other terms or conditions.*[115]

Tag-along right might be crucial for a private equity investing in business which are run by founders who are well equipped with the knowledge of the business and the market. In this instance, the private equity might not want to stay in the business if the founder is selling its shares; thus, it might want to reserve the possibility of selling its shares with the founder.[116]

3.2.2. Drag-along rights: this right enables the holder who wishes to sell its shares to a third party, to compel the other shareholders to sell his share to the buyer on the same terms and at the

[111] Delaware Code, title 8 sec 202(c)(4).
[112] Yates and Hinchliffe (n 43)159.
[113] The British Private Equity and Venture Capital Association (BVCA), 'A Guide to Venture Capital Term Sheet' (October 2007) 24.
[114] ibid cl 11,15.
[115] Anjarwalla & Khanna, 'Template Shareholders Agreement' (13 September 2016) clause 15.
[116] BVCA (n 113) cl 11,16.

same price.[117] A drag mechanism is very important to private equity investors and will be common to most transactions.[118] This right can be useful in the context of a sale where potential purchaser will want to acquire 100% of the shares of the company in order to avoid having responsibilities to minority shareholders after the acquisition.[119] This will make the shares of the majority shareholder attractive for potential purchasers and it allows the majority shareholder to obtain a higher price for its shares.[120] A template drag-along provision looks as follow:

> *If a transfer of Shares (the **Relevant Shares**) would result in a person or persons acting in concert (the Purchasing Group) holding or increasing their shareholding in the Company to [ ]% or more of the issued share capital of the Company, the Purchasing Group shall have the option (the Drag Option) to require the other Shareholder(s) (the Dragged Shareholder(s)) to each transfer a pro rata proportion of their shares (the Dragged Shares) to the Purchasing Group.*[121]

If the drag-along is applicable against the private equity, it may require that certain exceptions are included in drag-along provisions for situations which will exclude its obligation to sell its shares. One situation would be when the fund is required to provide to the purchaser representations and warranties concerning the company or covenants such as non-compete and non-solicitation of employees.[122]

In order to facilitate its enforcement and to ensure that the relevant share transfers can be delivered, a drag-along right can be supported by a power of attorney.[123] The power of attorney can be given to an independent third party who will execute the share transfer on behalf of the minority shareholder after verifying that the terms of the share transfer are in accordance with the shareholders' agreement or articles of incorporation. This will prevent uncooperative minority shareholder from blocking the drag.

[117] Yates and Hinchliffe (n 43)157.
[118] ibid.
[119] BVCA (n 113) cl 12,16
[120] Markus May, 'Shareholder Drag-Along Rights in Illinois' (2012) 100(6) Illinois Bar Journal, 320.
[121] Anjarwalla & Khanna (n115) clause 16.
[122] May (n 120).
[123] Yates and Hinchliffe (n 43)157.

Overall, exit rights give the private equity additional power and protects it from being forced to engage in negotiation during exit.[124]

3.3. Location of Exit Clauses: Articles of Association or Shareholders' Agreement?

One of the main questions in Ethiopian legal practice is in which legal document to incorporate exit clauses, in the articles of association or in shareholders' agreements.

The Commercial Code recognizes two mandatory corporate governance documents, AOA and the memorandum of association.[125] The articles and memorandum of association are binding on all shareholders of a company. Further, they are public documents required to be authenticated and registered at the public notary.[126] The memorandum of association is required to contain clauses on the business purpose of the company, the amount of capital subscribed and paid up, the manner of distributing profits, the number of directors and their powers, auditors, and agents of the company.[127] These clauses deal with the scope of the company's activities as well as its relation with third parties thereby enabling the shareholder, creditors and those who deal with the company to know the permitted activity range of the company.[128]

On the other hand, the AOA governs the operation of the company and the Commercial Code suggests that it follows the model to be supplied by the Ministry of Trade.[129] As of now, there is no officially endorsed model AOA. However, in practice, the AOA contains clauses, which deal with the power of shareholders meeting, quorum and majority required to pass decisions, rights and obligations of shareholders, and requirements in relation to transfer of share. These clauses are in practice mostly a duplication of the provisions of the Commercial Code in relation to these matters. There have been instances where the officials of a public notary office have refused to

[124] Carsten Bienz & Uwe Walz, 'Venture Capital Exit Rights' (22 November 2010) 1 <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1530-9134.2010.00278.x> accessed 12 March 2020.
[125] Commercial Code (n 69) art 314(3), the articles of association forms part of the memorandum of association and should be attached to it.
[126] Authentication and Registration of Documents Proclamation No.922/2015, *Federal Negarit Gazeta*, 22nd year No. 39, 15 February 2016, art 9(1(c)).
[127] Commercial Code (n 69) art 313.
[128] Jetu Edosa Chewaka,'Introducing Single Member Companies in Ethiopia: Major Theoretical and Legal Consideration' (Anchor Academic Publishing 2016) 102.
[129] Commercial Code (n 69) art 314.

register AOA, which contained exit right clauses. To overcome this bureaucratic challenge, private equity transactions incorporate exit right clauses in shareholders' agreements.

Shareholders' agreements among two or more shareholders of a company to govern their relationship are commonly used in connection with private equity investments in other jurisdictions[130] and it is also becoming prevalent in private equity deals in Ethiopia. Unlike AOA, shareholders' agreements are not publicly accessible,[131] which will make it an ideal option for shareholders who want to keep the terms of their agreement private. The key challenge in using shareholders' agreements is the failure of the Commercial Code to characterize it as a corporate governance document.[132] Thus, it is uncertain what kind of factors Ethiopian courts would consider in deciding on the validity of the shareholders' agreements. While deciding on the validity of shareholders' agreements, Ethiopian courts must take into consideration the freedom of contract principle enshrined into the Civil Code. In accordance with the Civil Code, a contract is binding on the parties and valid unless its object or the obligation under it is unlawful or immoral.[133] Aside from the issue of duress or fraud,[134] the court should assess the purpose or object of the shareholders' agreement and hold it valid if it is not against mandatory legal provisions or public policy.

In general, the placement of a particular arrangement into a certain formalized document should be irrelevant for its validity.[135] Accordingly, the main determining factor in deciding in which legal document to incorporate exit clauses should be the shareholders' intention to bind all the shareholders and/or the choice to make the agreement publicly accessible or not.

3.4. Validity and Issues That Can Be Raised Against Exit Clauses Enforcement

The Commercial Code neither recognizes nor prohibits exit right clauses. In the absence of clear legal provisions or developed legal practices in this area, the main question private equity investors

[130] Corporation Law Committee of the Association of the Bar of the City of New York 'Enforceability and Effectiveness of Typical Shareholders Agreement Provisions' (2010) Vol.65 The Business Lawyer, 1155.
[131] Mock, Sebastian, Csach, Kristian, Havel and Bohumil (eds), *International Handbook on Shareholders´ Agreements: Regulation, Practice and Comparative Analysis* (Walter de Gruyter GmbH 2018) 6.
[132] See section 3.3.
[133] Civil Code of the Empire of Ethiopia Proclamation No.165/1960, *Negarit Gazeta,* 19th Year No.2, 5 May 1960, art 1715 and 1716.
[134] ibid art 1704 and 1706.
[135] Mock, Sebastian, Csach, Kristian, Havel and Bohumil (n 131).

have is whether or not exit right clauses are legal and enforceable in Ethiopia? This paper argues that despite the lack of a clear legal provision or court decision, exit right clauses should be treated as valid and enforceable in Ethiopia for the following reasons. First, it is plausible to assume that anything which is not prohibited is valid and enforceable, or second, shareholders are allowed under the Commercial Code to agree on exit clauses. However, it should be noted that the enforcement of drag-along and tag-along clauses is more challenging in PLCs compared to share company as these clauses do not function properly in PLCs since the entrance of new shareholder in any case requires the approval of a qualified majority of shareholders. Thus, the analysis below will primarily focus on a share company.

The mandatory provisions of the Commercial Code, which the memorandum and AOA cannot deviate from, include quorum and majority requirements[136] and free exercise of voting rights[137]. Restriction on transfer of share in the form of compulsory share transfer provisions such as drag-along right are not against the mandatory provisions of the Commercial Code. The obligation to sale shares or to oblige one to buy shares do not violate voting rights or the majority or quorum requirements to adopt a decision. In the circumstance where an act is not against the mandatory statutory provisions, it is plausible to assume that it is allowed.[138] This is in line with the need to create legal certainty and enabling environment to the business community.

Moreover, the Commercial Code states that shareholders have an inherent membership right, which includes the right to take part in a shareholders meeting, the right to be a member, to vote, to challenge a decision of the company or to receive dividends and share the estate in a winding up.[139] These rights are not dependent on the decision of the general meeting of shareholders or board of directors. However, these rights can be set aside if the shareholders consented to their restriction.[140] For instance, if a company issues preference shares, which restrict the voting right of the holder to certain issues, this is not against the inherent right to vote as the shareholder buys

[136] Commercial Code (n 69) art 399(3).
[137] ibid art 410.
[138] Such kind of argument exists in public international law based on the Lotus principles which provides that sovereign states mat act in any way they wish so long as they do not contravene an explicit prohibition. Space Legal Issue, the Lotus Principle, <https://www.spacelegalissues.com/the-lotus-principle/> accessed 2 June 2020.

[139] Commercial Code (n 69) art 389(2).
[140] ibid art 389(1).

the preference shares with knowledge and consent to the limitation.[141] One of the inherent rights of a shareholder is to be a member of the company. A drag-along right has the effect of ending the shareholder status of a person who is being dragged. Like the right to vote the right to be a member can also be restricted or set-aside if the shareholder gave its consent. This restriction can be spelled out in the AOA; therefore, a shareholder will automatically accept and give its consent to the limitation when it subscribes shares. This article has the effect of making drag-along clauses valid provided that the shareholder that is being dragged has consented to the inclusion of the clause. This argument is in conformity with the Commercial Code's intended goal of avoiding majority rule on some issues.[142] This will protect minority shareholders from being forced out of the company through majority vote. In accordance with this, a drag-along provision which will be inserted in the AOA through amendment might not pass this test if the shareholder who is being dragged has opposed this amendment at the time. Accordingly, a drag-along provision, which is incorporated under the AOA or a shareholders' agreement, should be valid against a shareholder who has given its consent.

The above arguments should not let one believe that all is good with exit rights. Rather, Article 333(3) of the Commercial Code, which requires restrictions on transfer of shares not to have an effect of preventing the shareholder from transferring its shares or causing serious damages to a transferring shareholder, might be used to block the enforcement of tag-along rights. Potential purchasers might not be willing to also buy the shares of the minority shareholder, thus, hindering the majority shareholder from transferring its shares. In this circumstance the majority shareholder might claim that there is no market for 100% of the company's shares and the tag-along right is preventing it from transferring its shares consequently causing damage to it.

3.5. Lessons from UK and USA

As drag-along right is a compulsory transfer of shares, even if it is provided under a shareholders' agreement or AOA, its enforcement might be challenged, and this also applies to jurisdictions which have the best corporate practice. It is highly likely that a court will be involved in reviewing the validity of exit clauses elements like purchase price or fulfillment of triggering conditions.

[141] Peter Winship (ed), 'Background Documents of the Ethiopian Commercial Code of 1960' (Faculty of Law Haile Sellassie I University) 65.
[142] ibid.

Thus, in order to avoid long court litigation on the issue, it is advisable, while drafting the clauses, to be precise. The following lessons can be taken from cases and corporate practices in the sector:

(i) **Minimum price:** the drag-along clause should incorporate a minimum price threshold to be paid for the dragged shares.[143] The price should reflect the value of the portfolio company. This will protect the minority shareholder from being dragged at an undervalue and this would also minimize dispute in relation to the good faith nature of the proposed drag price.

The UK *Cunningham v Resourceful Land Ltd and others*[144] case is a good example to show that shareholders should be careful on the wording of the drag-along clause. The case involved Mr. Kenny, Mr. Nicholas and Mr. Jonathan (known as syndicated shareholders) who own half of the issued capital of Resourceful Land Ltd (RLL) and Mr. Cunningham and Mr. Ring who are minority shareholders in RLL.[145] The shareholders of RLL entered into a shareholders' agreement. The drag along clause stated that if the Syndicated Shareholders wish to transfer all their shares to a bona fide arm's length purchaser, they have the option to require the remaining shareholders (Called Shareholders) to sell their shares too.[146] The shareholders agreement states that if the Called shareholders fail to execute the transfers then upon the company receiving the purchase monies or any other consideration payable for the shares the Syndicated Shareholders may execute the transfers on their behalf.[147]

Funding for the business was obtained from Privilege Project Finance Limited (Privilege). When further finance was required, Privilege agreed to provide it in return for an equity stake in RLL. In order to achieve this, it was agreed that Privilege would incorporate a new subsidiary to buy the shares in RLL from its shareholders and, in exchange, issue those individuals new shares in the subsidiary.

[143] PWC Legal, 'Tag along and drag along clauses in shareholders' agreements', (2019) 4 <https://www.pwclegal.lu/docs/publications/tag-along-and-drag-along-clauses-in-shareholders-agreements.pdf> accessed 30 March 2020.
[144] *Cunningham v Resourceful Land Ltd and others* [2018] EWHC 1185(Ch) [2 May 2018].
[145] ibid 4
[146] ibid 5
[147] ibid 6

The syndicated shareholders of RLL agreed to this plan and served a notice to the other shareholders imposing the drag-along.[148] The transfer of the minority shareholders shares were completed under the provisions of the drag along.

The minority shareholder has brought a suit claiming that the drag-along clause cannot be triggered for non-cash consideration as the word "sale" in the shareholders' agreement was only intended to cover a sale of shares for cash and not shares.[149] The court decided that the language of the shareholders agreement is permissive as it provides "any other consideration" and that is wide enough to permit a non-cash transfer.[150] Thus, the Syndicated Shareholders have successfully triggered the drag-along clause.

The minority shareholder also claimed lack of good faith by Privilege. The court did not accept this claim as there was no evidence that the transfer had been at an undervalue and all shareholders were treated equally and received the same proportionate shareholding in the subsidiary.[151] Further, the claimant failed to establish the existence of any viable alternative funding for RLL.[152] Thus, privilege has acted in good faith.

(ii) **Bona fide purchaser**[153]: the rule of bona fide purchaser is to protect a purchaser who engaged in a transaction with good faith. The purpose of drag-along right is to guarantee smooth exit to the private equity fund. Thus, it should not be used to sale the minority shareholder's shares at undervalue by conspiring with the purchaser. Accordingly, the purchaser must be a bona fide third-party purchaser.

The other claim the minority shareholder raised in *Cunningham v Resourceful Land Ltd and others* case was that the purchaser is not a 'bona fide arm's length purchaser'. The Court has decided that the sale was on-arm's length because the parties have acted for their

[148] ibid 21
[149] ibid 30
[150] ibid 32
[151] ibid 54
[152] ibid 66
[153] As per *Black's Law Dictionary,* a bona fide purchaser *refers to one who buys something for value without notice of another's claim to the property and without actual or constructive notice of any defects in or infirmities, claims, or equities against the seller's title; one who has in good faith paid valuable consideration for property without notice of prior adverse claims.*

respective interest and there was no evidence indicating collusion or side deal or special inducement.[154]

(iii) **Triggering event:** the clauses must provide the required thresholder that will trigger exercise of the rights. In relation to tag-along the minority shareholder might be allowed to only exercise its right when the majority shareholder sale all its shares or the minority shareholder might be allowed to tag-along on a pro rata basis whenever the majority sale any of its shares.[155] The same applies to drag-along right, the clause has to clearly provide when the majority shareholder can drag the minority shareholder.

(iv) **Conflict with other rights:** in *Minnesota INVCO of RSA #7 v. MIDWEST WIRELESS HOLDINGS LLC*[156] case, the minority shareholder claimed that the drag-along provision, which was adopted in a later agreement, conflicted with its right of first refusal that had been incorporated into an earlier operating agreement of the limited liability company. The Delaware Court of Chancery has decided that the drag-along right is enforceable against a minority shareholder because the later agreement, which provides the drag-along right, governs the transaction. This case indicates that drag-along rights can come into conflict with other rights at the time of share transfer. In order to avoid conflict, clauses that deal with share transfer should be drafted in a way one follows the other. Usually the right of first refusal have priority over drag-along right i.e. the minority shareholder will be dragged if it is unwilling to purchase the shares of the majority shareholder on the same price proposed by the bona fide purchaser.

Conclusion

Due to the non-existence of stock exchange in Ethiopia private equity funds cannot exit the Ethiopian market through IPO. Private sale of shares remains to be the visible exit strategy for private equity funds in Ethiopia. The other main issue in relation to exit is the uncertainty as to the enforcement of clauses like drag-along and tag-along. The author argued that exit clauses should be enforced in Ethiopia as they are not against mandatory provisions of the Commercial Code.

[154] *Cunningham (n144)* 37, 38 and 63

[155] Aaron Kok and Nicholas Wee, 'Navigating a Shareholders Agreement: Drag Along and Tag Along Rights', *LEXOLOGY* (26 April 2019) <https://www.lexology.com/library/detail.aspx?g=6c1a4968-6765-4660-bb45-b4a90c282d59> accessed 10 April 2020.

[156] Minnesota Invco of RSA#7, Inc. v. Midwest Wireless Holdings LLC, 903 .2d 786(Del.Ch.2006).

Furthermore, the Commercial Code appear to allow exit clauses if the shareholder gave its consent. The solution for the uncertainty would be to amend the relevant provisions of the Commercial Code and confer more freedom to shareholders to regulate their relationship.

CONCLUSION

Private equity funds can provide funding to a portfolio company in exchange for an equity stake in the company. Thus, in countries where there is limited access to finance private equity funds can play a gap-filling role. The role of private equity is not limited to providing finance rather it contributes to the growth of the portfolio company through expanding product line and by improving operation.

Creating a conducive legal environment is crucial in attracting private equity funds. In Ethiopia there is no legal framework which will enable local fundraising for the purpose of investment. All private equity funds which have invested in Ethiopia are incorporated abroad. In order to benefit from the idle local capital, the Ethiopian government needs to undertake a legal reform and allow funds to be raised locally.

Private equity funds are typically raised with an expected life of around ten to twelve years. Thus, by the end of the cycle the private equity fund must exit the portfolio company and distribute its profit to its investors. Thus, exit is one of the crucial cycles of a private equity investment. In Ethiopia, different laws regulate different aspects of the exit process of a private equity fund. The notable ones are in the area of investment regulations, foreign exchange, tax, company law and competition. Ethiopia has recently amended its investment regulation resulting in the opening of more sectors for foreign investors. On the contrary the foreign exchange regulation has been a key area of challenge for the private equity funds as it affects the operation of the portfolio company and might delay the private equity fund exit. To solve the foreign exchange shortage the government has to work towards enhancing export-oriented business.

The other key area of regulatory challenge is company law. Due to lack of legal framework exiting the portfolio company through IPO is impossible in Ethiopia. However, the Commercial Code provides private sale of shares and buy-back as an exit option. The enforcement of shareholders' agreements and exit clauses is uncertain in Ethiopia as the Commercial Code is silent on the subject matters. The uncertainty might discourage private equity funds from investing in Ethiopia.

This thesis took the view that shareholders' agreements are legal and enforceable due to the freedom of contract principle enshrined into the Civil Code. In relation to exit clauses the author argued that exit clauses are valid and should be enforced because (1) there is no clear prohibition against them or they are not contrary to mandatory provisions of the Commercial Code or (2)

shareholders are allowed under the Commercial Code to agree on exit clauses provided that the shareholder that is being dragged agreed to it. Notwithstanding the above arguments, when drafting exit clauses, special focus should be given to clauses dealing with triggering event, minimum price and identity of the purchaser.

The main lesson that can be drawn from this is the need to amend the Commercial Code to create certainty.

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