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Economic analysis of limited liability of shareholders under ethiopian company law

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Abstract
Without exaggeration, a company with limited liability protection is the greatest invention ever to make an unlimited profit with limited liability or without risk to personal assets of shareholders. As per this doctrine of limited liability, the shareholders are liable for the company's debts only to the limit of their investment in the company. This triggers the issue of its economic efficiency. In this article, the researcher has theoretically examined the economic efficiency of companies with limited liability from different stakeholders' perspectives. The analysis of productivity, bargaining theory, transaction costs, agency costs, social costs, and enforcement costs revealed that in the case of Share Company, generally, the benefits of limited liability outweigh its costs. Hence, limited liability is an efficient rule that needs to be maintained. However, to reduce costs and thereby ensure its overall efficiency mandatory insurance, the unlimited liability of a director, veil piercing doctrine, minimum capital requirement, and legal reserve should be made functional based on economically sound principles. Concerning tort creditors, unlimited liability is an economically efficient rule. Hence, unlimited liability should be introduced concerning the claim of tort creditor. Alternately, the author argues for the introduction of mandatory insurance coverage to reduce uncompensated risk transfer to tort creditors. With respect to a private limited company, the difference between limited and unlimited liability on its productivity and transaction cost is minimal. Thus, the unlimited liability rule is recommended for private or closely held companies to minimize the social cost of limited liability.

Keywords: limited liability, unlimited liability, efficiency, and company

1. Introduction

In Ethiopia, shareholders have limited liability for the company's debts [1]. As per this majestic doctrine [2] of limited liability, the shareholders are not liable for the company's debts more than the amount of their investment in the company unless the wall or veil of limited liability is pierced under the doctrine of veil piercing [3]. Limited liability does not, however, mean no liability. The shareholders may always lose the amount they have invested in the company. In evaluating the economic efficiencies of limited liability, its costs, and benefits to different stakeholders such as shareholders, creditors, and the whole economy needs consideration. In analyzing the economic efficiency of limited liability of shareholders, Share Company (hereinafter "SC") and Private Limited Company (hereinafter "PLC") would be considered separately when it deems necessary. In the context of this article, unless the context require otherwise, share company which is formed between the founders and those whose members are less than fifty are treated as PLC. Finally, economic analysis is theoretical and not statistical.

As of today, the economic efficiency of limited liability is a debatable issue. Accordingly, on one hand, limited liability has been accused of causing a moral hazard by creating uncompensated transfers of business risks to creditors, creating incentives to engage in risky and fraudlent investments, and serving as means of liability evasion [4]. On the other hand, it has been appreciated for ensuring efficiency and productivity by saving negotiations costs [5], reducing monitoring and information costs [6], making company default risks rest on creditors [7], making stock markets operative and effective [8], and encouraging investment and entrepreneurship [9]. This article, examine the validity of arguments advanced for and against limited liability of shareholders based on economic analysis. The remedies of social costs or negative externalities of limited liability is also analyzed.

[1]The Two companies with limited liability protection for shareholders are Share Company (SC) or Companies Limited by Share and PLC (Commercial Code, Art 304 &510(1)). Limited partners under limited partnership have also limited liability protection shell (Commercial Code, Art 396). However, limited partnership is out the scope of this article. Article 296 states unambiguously that limited partners in a limited partnership are liable only to the extent of their contributions. In this regard, a limited partner is like a shareholder in a company. See also Michael P. Porter, *Unlimited and Limited Liability in the Commercial Code of Ethiopia*, 4 ILSA JOURNAL OF INT'L & COMPARATIVE LAW 1083, 108-1102 (1998).

[2] Frank H. Easterbrook and Daniel R. Fischel, *Limited Liability and the Corporation*, 52THE UNIVERSITY OF CHICAGO LAW REVIEW 89, 89 (1985).

[3]Easterbrook & Fischel, *supra note 2,* at 90; Paul Halpern, Michael Trebilcock and Stuart Turnbull, An *Economic Analysis of Limited Liability in Corporation Law*, 30UNIVERSITY OF TORONTO LAW JOURNAL, 117,117 (1980).

[4] Henry Hansmann and Reinier Kraakman, Toward Unlimited Shareholder Liability for CorporateTorts, (Accessed at 21-04-2019) http://www.law.harvard.edu/programs/olin_center/papers/pdf/Hansmann_94.pdf.

[5] Richard A. Posner, *the Rights of Creditors of Affiliated Corporations,* 43 UNIVERSITY OF CHICAGO LAW REVIEW 499 (1975).

[6]*Id.*

[7] Easterbrook & Fischel, *supra note* 2, at 90; Halpern, Trebilcock and Turnbull, *supra note* 3, at 91.

[8] Easterbrook & Fischel, *supra note* 2, at 90; Halpern, Trebilcock and Turnbull, *supra note* 3, at 127-131.

[9]Halpern, Trebilcock and Turnbull, *supra note* 3, at 118.

2. Productivity Analysis

2.1 Investment

The limited liability would facilitate investments of savings by investors [10]. The limited liability encourages investment through protecting the personal assets of the shareholders via the corporate veil from claims of the company's creditors. The reverse is true for the unlimited liability regime. Under the limited liability regime, personality, and personal asset of the shareholder is immaterial. In doing so, it encourages the investment of both those who know and do not know each other. This tends to ensure that huge investors are pulled to undertake mega investments or projects [11]. With this regard, thousands of shareholders and relatively huge capital in the financial institutions of Ethiopia is living witnesses. The multinational enterprise or corporation is unthinkable in the absence of limited liability. The limited liability encourages investment and investor not only through the protection of personal assets of the shareholders from the claim of the corporate creditor. But also it encourages investment through the reduction of monitoring and information cost, ensuring the free transfer of a share, facilitating stock market operation, and allocation of risk to wider corporate creditors. In conclusion, limited liability would lead to a net increase in the total level of economic activity and promote entrepreneurship [12]. On the other side, limited liability would probably become an incentive to induce firms to undertake excessive risky investment activities and encourages irresponsible management [13]. To be specific, limited liability encourages risky and illegal investment which affects investors and creditors.

2.2 Stock Market Operation

The absence or presence of risk to personal assets of the shareholders and the cost of obtaining information about the wealth of shareholders have a great impact on the efficient operation of the stock market. In the limited liability world, the bankruptcy of the company have no risk to the personal assets of shareholders [14]. This encourages the purchasing of shares by investors and ensures the efficient operation of the stock market. Under limited liability, shareholders and potential buyers of shares need to know nothing regarding the creditworthiness of firms and shareholders for their personal wealth to remain secure. Thus, the value of the share is not affected by fluctuation in the creditworthiness of shareholders [15]. This makes the stock market operative. However, this does not mean the potential buyer of share does not incur costs to examine the future profitability of the firm. A potential investor may incur costs to examine the future profitability of the company. However, the cost to get and examine the future profitability of the firm is very low as it is possible to easily infer from the value of a share in the stock market. The reverse is true for the unlimited liability regime [16]. However, in case there is no transaction costs, the liability rule make no difference in the operation of the stock market. Otherwise, the stock market is operative only under a limited liability regime. Thus, limited liability is necessary for the existence of an organized stock market.

3. Bargain Theory Analysis

Usually, the application of limited liability to the contractual creditor is justified by bargain theory [17]. As per this theory, the company and creditors would have bargained for limited liability even if it was not the default liability arrangement [18]. Altering it would only create transaction costs, as parties would need and prefer to negotiate for it [19]. Therefore, the limited liability rule is economically efficient as it avoids the cost of negotiation [20]. Adherents to the bargain theory also believe that the prevalence of limited liability attests to the efficiency of the rule [21]. This theory is flawed in many respects. *First*, it claims that creditors of a company prefer limited liability, which is unsound. Because, one would reasonable expect creditors to prefer the best credit protection possible, which is available under unlimited liability. *Second*, even when two parties negotiate their desire is antagonistic. As a result, the parties' skills and bargaining power determines the outcome of the negotiation. A party with greater bargaining power is more likely to reach the outcome it desires. Save the exception, the party with greater bargaining power is companies with limited liability. *Third*, bargaining power and negotiation cost is crucially dependent on default legal rule and not contractual agreements. The negotiation cost of altering the default rule is greater than the negotiation cost of maintaining the default rule. When a creditor with low bargaining power wants to negotiate against the default legal rule, its negotiation cost is likely to be high. However, when a creditor with high bargaining power wants to negotiate to maintain default legal rule, its negotiation cost is likely low

In general, contrary to the efficient bargaining theory, the fact that most contracts incorporate limited liability is not a representation of the general preference of contractual parties. It is also not evidence of the rule's efficiency. Rather, it merely reflects the prevalent balance of bargaining power between company and creditor, or mandatory default rule. Moreover, it is more costly for the creditor to negotiate for shareholder unlimited liability when limited liability is the default rule than for that creditor to preserve shareholder liability when unlimited liability is the norm. The creditors prefer unlimited liability but may find it too costly to negotiate for it. Therefore, limited liability neither minimizes negotiation costs and indicates the rule's efficiency nor represents the parties' preferences.

4. Transaction Cost Analysis

The transaction cost incurred by shareholders and creditors are different based on the size of the company and bargaining power.

[10] Halpern, Trebilcock and Turnbull, *supra note* 3, at 119.
[11] William J. Carney, Limited Liability, (Accessed 23 April 2019), https://reference.findlaw.com/lawandeconomics/5620-limited-liability.pdf,, 659, https://ssrn.com/abstract=50563, or http://dx.doi.org/10.2139/ssrn.50563, 670.
[12] Halpern, Trebilcock and Turnbull, *supra note* 3, at 118.
[13] William J. Carney, *supra note* 11, at 659.
[14] Halpern, Trebilcock and Turnbull, *supra note* 3 at 124.
[15] Philip Örn, *Piercing the Corporate Veil– a Law and Economics Analysis*, FACULTY OF LAW UNIVERSITY OF LUND MASTER THESIS, 1, 12 (2009).
[16] Halpern, Trebilcock and Turnbull, *supra note* 3 at 130 & 131.
[17] Thomas K. Cheng, *an Economic Analysis of Limited Shareholder Liability in Contractual Claims,* 12 BERKELEY BUSINESS LAW JOURNAL, 112, 124 (2014).
[18] *Id.*
[19] *Id.*
[20] Cheng, *supra note,* 17 at 127.
[21] Cheng, *supra note,* 17 at 128.

4.1 Negotiation Cost

There is an assumption that adopting limited liability as a default rule saves negotiations costs because if it is adopted as a default rule, the parties cannot incur time and resources to ensure a limited liability arrangement, which they generally prefer. This is based on the assumption that the law provides maximum freedom to conclude contracts. This conclusion is wrong because of the following reasons. *First*, limited liability of shareholder arises not from the negotiation of parties but from clear provisions of the law upon incorporation in the form of company form which may not change by negotiation. *Second*, even in case the limited liability is not adopted as a default rule and arises from the contract, the contract is not a result of negotiation, which reflect the interest of all contracting parties. Instead, the contract is concluded based on a pre-determined (without negotiation) terms and formats designed by the company for its own best interest. This happens because of the strong bargaining power of the company as compared to creditors (save exception). As a result, limited liability is not a mutually desired allocation of business failure, which arises from negotiation. Thus, the failure to adopt limited liability as a default rule would not increase the cost of negotiation or transaction costs of both companies and their creditors. However, the adoption of limited liability as a default rule would minimize the transaction costs incurred by parties for the conclusion of the contract (excluding negotiation). Besides, the limited liability regime avoids transaction costs incurred by the shareholder in the allocation of business failures among each other.

The tort creditors have no contractual relation with companies. The tort creditor is not able to negotiate for a change of default liability rule [22]. Hence, the above analysis does apply to tort creditors.

4.2 Monitoring Cost

Shareholders monitor the action of management and asset of other shareholders is relative to the degree of the risk of business failure [23]. Accordingly, if the personal assets of shareholders were not at risk, the shareholders' monitoring costs of both management [24] and other shareholders, would be minimal. As a result, under limited liability rule cost of monitoring action of management and assets of other shareholders to secure their assets from risk is minimal. This is because the degree of the risk that the business failure poses to the personal assets of shareholders is low. However, the shareholders may incur costs on monitoring the action of management to ensure the profitability of the company and protecting their investment in the company. Under unlimited liability, shareholders would incur monitoring costs in closely watching the actions of the management and asset of other shareholders to protect its personal assets from the risk of business failure [25], ensure the profitability of the company [26], and protecting their investment in the company [27]. Under this regime cost of monitoring is different based on the size of the company. Accordingly, in the case of PLC, the cost is minimal but in the case SC., it is relatively higher since supervising, the assets of a large number of shareholders require a higher cost.

The creditor (except tort creditor) incurs the monitoring cost. Under limited liability, creditors may not have a claim against the personal assets of shareholders. Because of this, the monitoring cost incurred by the creditors to monitor the wealth of shareholders is null. Despite this, there is a monitoring cost incurred by the creditor to monitor the assets and management of the company. Because the action of management may increase risks of creditors whereas the asset of the company is the only available wealth to satisfy the claim of creditors. Under unlimited liability, the monitoring costs would be much greater because the information costs incurred by creditors in monitoring the changing wealth of changing shareholders and actions of management are likely to be substantial. Under unlimited liability, the cost of monitoring increases with the size of the company.

4.3 Information Cost

Information costs vary across different *groups of creditors* [28]. This is due to their varying degrees of bargaining power and disparate abilities to obtain and analyze sensitive financial information from the debtor company [29]. Information costs can be divided into access costs and analysis costs [30]. Access costs refer to the costs incurred by a creditor to obtain information from the debtor company and [31] the analysis costs refer to the costs incurred by the creditor to process and analyze the information obtained from the debtor [32]. Creditors with strong bargaining power and experience (expertise) incur lower access and analysis cost [33]. Information cost is incurred by both shareholders and creditors. The cost incurred by creditors and shareholders is different under limited and unlimited liability regimes based on the size of the company, bargaining power, and experience of the parties.

In case of limited liability, the *credito*r incurs such costs only concerning only the initial capital and ongoing activities of firms. Thus, unlike the case of unlimited

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[22] Ali Imanalin, *Rethinking Limited Liability*, CAMBRIDGE STUDENT LAW REVIEW, 89, 91 (2011).

[23] Carney, *supra note* 11 at 670.

[24] Includes management body (board of director, CEO (manager)) and staff.

[25] Black, Miller and Posner, 'An Approach to the Regulation of Bank Holding Companies' (1978) https://www.jstor.org/stable/pdf/2352274.pdf, 379; Jensen and Meckling, 'Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976), http://papers.ssrn.com/abstract=94043, 305.

[26] Örn, *supra note* 15, at 12; Jonathan R. Macey, the *Limited Liability Company: Lessons for Corporate Law*, 73WASHINGTON UNIVERSITY LAW QUARTERLY, 433,437 (1995).

[27] Örn, *supra note* 15, at 12; Jonathan R. Macey, *supra note* 25, at 433.This happen because of: 1) the reduction of asset of other shareholder increase the chance of being a target by creditor; and 2) unanticipated action of the management increase the risk of shareholders. In addition to cost for securing personal asset from risk of business failure, the shareholder incur cost on monitoring action of management to ensure profitability of company and protecting their investment in company.

[28] The two type of creditor are *voluntary* and *non-voluntary* creditor (tort creditor). The voluntary creditor includes *financial creditor, consumer, trade creditor, and employee*. *Financial creditor* provide loan or purchase bond or debenture from the company and creditor thereof. *Consumer* buy and consume good and services of the company and creditor for damage arise from consumption or non-delivery of good and services by company. *Trade creditor* sell services, and good and creditor for payment thereof. *Employee* give services to company and creditor for payment thereof.

[29] Cheng, *supra note* 17, at 122.

[30] Cheng, *supra note* 17, at 122.

[31] Cheng, *supra note* 17, at 122.

[32] Cheng, *supra note* 17, at 122.

[33] Cheng, *supra note* 17, at 123-125.

liability, the creditor may not incur the cost of accessing and analyzing information about the personal wealth of shareholders. The cost of accessing and analyzing information about the firm and management thereof is determined by the size of the company, bargaining power of creditor, the expertise of creditor, and transparency of the operation of the company and management. In case, the creditors have strong bargaining power and expertise in accessing and analyzing information, the information cost would be reduced. In contrast, in case the creditors have weak bargaining power and low expertise in accessing and analyzing information, the information cost would increase. The increase in the size of the company increases the cost of information unless the information is substantially public. Thus, information cost is minimal in the case of PLC whereas it is relatively higher in the case of S.C. In case the information is substantially public the size of companies does not affect information costs. In conclusion, both under limited and unlimited liability, the information costs make minimal or no difference in the case of PLC. The creditors can transfer information costs in the company by imposing high interest (the financial creditor) or high price (trade creditor), or high wage (employee).

Under both limited and unlimited liability, the *shareholders* incur information cost to access and analyze information regarding the assets and the impact of new investments of the companies. Besides, shareholders of the firm with unlimited liability incur information cost to know about the wealth of the other shareholders at the time of membership and during the membership term. Shareholders of the firm with limited liability do not incur information cost to know about the wealth of the other shareholders at the time of membership and during the membership term. Thus, the information costs for the shareholder is minimal under a limited liability regime.

5. Agency Cost

A company with limited liability protection for shareholders (especially S.C) facilitates the division of labor [34] through the separation of ownership and management [35]. The separation of investment and management requires firms to create devices by which these shareholders and management monitor each other and guarantee their performance. Neither group will be perfectly trustworthy [36]. Moreover, management who do not obtain the full benefits of their performance does not have the best incentives to work efficiently. The costs of the separation of investment and management also known as agency costs may be substantial [37]. Nonetheless, the costs generated by agency relations are outweighed by the gains from separation and specialization of function [38]. Limited liability reduces agency costs in a different way [39]. First, limited liability decreases the need to monitor because shareholders have no incentive except protection of their investment to do so [40]. Second, limited liability reduces the costs of monitoring other shareholders by avoiding the cost of monitoring the wealth of other shareholders [41]. Third, by promoting the free transfer of shares, limited liability gives managers incentives to act efficiently [42]. Fourth, limited liability makes it possible for market prices to impound additional information about the value of firms [43]. Fifth, limited liability allows for more efficient diversification [44]. Finally, limited liability facilitates optimal investment decisions [45].

6. Enforcement Cost

In the case of limited liability world, upon default of the company, the trustee and creditors pursue only the asset of the company and not the wealth of each shareholder. Thus, the bankruptcy cost is lower under the limited liability regime as compared to the unlimited liability regime under which trustee and creditors pursue the wealth of the firm and whole shareholders. However, such a difference in cost is minimal concerning PLC. This is because of the size of the company and the number of shareholders determines the amount of bankruptcy cost.

7. Social Costs Analysis

Companies with limited liability protection for its shareholder is not righteous entities, which are free from defect. Those who criticize limited liability did so because it would result in uncompensated transfers of the risk of business failure from shareholders to creditors, encourage risky investment, and promote fraudulent investment schemes for purpose of liability evasion. The limited liability, which externalizes risks of business failures to creditors, enables liability evasion, and gives incentives to undertake risky investments cause a moral hazard, affect commercial integrity, and reduce the overall efficiency of limited liability.

7.1 Risk Transfer

Without limited liability, every share would place a shareholder's personal assets of shareholders at risk [46]. However, with limited liability, the personal assets of the shareholder is free from risks of business failure. In doing so, limited liability does not eliminate business failure and risk thereof but rather shifts some of the risks to creditors [47]. Limited liability has often been accused of transferring the risks of business failure from shareholders to creditors without compensation [48]. Concerning tort creditors, the transfer of risks without compensation is sound. Poisoner argues the voluntary creditors has been fully compensated. The financial creditor is compensated by higher interest rates, the employee is compensated by a high wage, a consumer is compensated by the lower price it pays, and the trade creditor is compensated with the high price paid [49]. Hence, limited liability does not externalize business risks to creditors. This argument is far from reality. Because, the

[34] Easterbrook & Fischel, *supra note* 2, at 94.
[35]Easterbrook & Fischel, *supra note* 2, at 94.
[36]Easterbrook & Fischel, *supra note* 2, at 94.
[37]Easterbrook & Fischel, *supra note* 2, at 94.
[38]Easterbrook & Fischel, *supra note* 2, at 94.
[39]Easterbrook & Fischel, *supra note* 2, at 94.
[40]Easterbrook & Fischel, *supra note* 2, at 94.

[41]Easterbrook & Fischel, *supra note* 2, at 95.
[42]Easterbrook & Fischel, *supra note* 2, at 94.
[43] Easterbrook & Fischel, *supra note* 2, at 96.
[44]Easterbrook & Fischel, *supra note* 2, at 96
[45] Easterbrook & Fischel, *supra note* 2, at 97.
[46]Henry G. Manne, *Our Two Corporation Systems: Law and Economics* 53 VIRGINIA LAW REVIEW 259 (1967).
[47] Easterbrook & Fischel, *supra note* 2, at 91.
[48] Jonathan M. Lander, A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy (accessed on April 23, 2019), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=3980&context=uclrev, 589; Halpern, Trebilcock and Turnbull, *supra note* 3 at 124.
[49] Lander, supra *note* 48, at 590-595; Halpern, Trebilcock and Turnbull, *supra note* 3 124.

interest rate of the lender, wage of an employee, and price of the product is not determined by future anticipated or unanticipated risks but it is determined by present market value or supply-demand interaction. Also, the wage of employees, the interest rate of the loan, and the price of products are not compensation for the risk but payment (profit) for the goods and services they provided. Even when it is considered as compensation, it may not be adequate to compensate for all risks since it is difficult to anticipate all risks. Liability is generally viewed as a device for minimizing the social cost of private activities, and for forcing actors to internalize the full cost of their actions [50]. An efficient liability system causes actors to consider the full cost of their actions [51]. Limiting liability does not cause actors to internalize the cost of their actions instead it subsidize risky behavior and allow some actors to externalize part of the costs of their actions. Thus, limited liability entitles shareholders to reap all the benefits and share of the losses with the creditors of their company. However, externalization of anticipated business risk to creditors under limited liability may be justified to encourage entrepreneurship and business activities.

Regarding the reason why creditor bears the risk of business failure, Richard Posner claim that creditors might be appropriate risk bearers because they are less risk-averse than shareholders or have superior information [52]. This is implausible. Creditors are generally more risk-averse than shareholders. Creditors is risk bearers because of superior information has considerably more appeal, but it does not explain the reason why involuntary (tort) creditors bear the risks. Moreover, though creditors may sometimes possess superior information, this will not always be true. On the contrary, we expect creditors to know less [53].

7.2 Liability Evasion

Limited liability of shareholders has often become a means of evading liabilities and of concealing the real interests behind the business [54]. This would probably reduce commercial integrity, which facilitates commercial transactions. In such a case, the only solution is lifting or piercing the corporate veil to make shareholders liable for debts of the company. Under unlimited liability, liability evasion and avoidance is minimal as a creditor have the right to claim from the personal wealth of shareholder in case of business failures. In contrast, under limited liability, liability evasion and avoidance is high as a creditor lack a right to claim from the personal wealth of shareholder in case of business failures.

7.3 Risky and Fraudulent Investment

Risky investments have greater risks and benefits. Limited liability entitles shareholders of a firm to reap all of the benefits of risky activities but does not bear all of the costs. Because shareholders loss only their investment whereas other cost is incurred by other creditors. Besides, the cost of risky investment does not affect the personal assets of creditors in case of business failure. In doing so, limited liability creates a moral hazard that is the incentive to engage in risky investment and transfer the risks thereof to creditors. The limited liability protection guards the personal property of shareholders against the claim of creditors. In doing so, limited liability of shareholders encourages fraudulent investment. In contrast, under unlimited liability, the personal assets of shareholders would not be free from claims of creditors. Hence, the unlimited liability of shareholders discourage fraudulent investment. The incentive to engage in fraudulent investment is lower under unlimited liability regime relative to limited liability. Following this, fraudulent investment is lower under unlimited liability as compared to a limited liability regime. The case between *Feven Zemen et al v. Askalukan Trading PLC and Other* persons show how limited liability encourages fraudulent investment [55].

8. Remedies of Limited Liability

Limited liability have defect like uncompensated risk transfer, liability evasion, and risky investment, which reduce its overall efficiency. Because of this, there is a need to provide remedies to reduce or avoid flaws of limited liability and thereby foster the productivity and efficiency of limited liability. Those remedies include mandatory insurance, the doctrine of corporate veil piercing, managerial liability, minimum capital requirement, and others.

8.1 Veil Piercing Doctrine

Defenders of limited liability argue that the doctrine of veil piercing avoids externalization of business risk and liability evasion problems of limited liability which result in an uncompensated transfer of risks. This argument is sound but not complete. Because business failure is not sufficient ground of veil piercing unless there is fraud or misrepresentation. As a result, veil piercing have no agenda of compensating risk of business failure but revealing misconduct committed behind the veil and discouraging such misconduct to ensure commercial integrity. Also, full compensation is not guaranteed by veil piercing. Even when it applies it is an *ex-ante* remedy. Therefore, the veil-piercing doctrine cannot be used to avoid and completely remove (but it may minimize under limited circumstance) externalization of business risk problems of limited liability [56].

8.2 Insurance

As indicated above risk transfer or externalization is the basic inefficiency of limited liability. The one remedy to this problem is insurance. The issue is who provides insurance. The limited liability is equivalent to insurance being provided by creditors. As a result, creditors are unwilling and have no incentive to provide market insurance. Likewise, shareholders are unwilling and have no incentive to provide insurance since their personal assets are free from the risk of company failure. Moreover, the transaction costs of shareholder and creditor individually purchasing insurance would be prohibitive. Each shareholder and creditor would have to negotiate with the

[50] Carney, *supra note* 11, at 665.
[51] Carney, *supra note* 11, at 665.
[52] Posner, *supra note* 5, at 499-505.
[53] Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 THE JOURNAL OF LAW & ECONOMICS 395(1993); Fama, Eugene F. and Jensen, Michael C., Agency Problems and Residual Claims <http://dx.doi.org/10.2139/ssrn.94032> accessed on April 23, 2019.
[54] Posner, *supra note* 5, at 500.
[55] *W/rt. Feven Zemen and Others v. Askaluka Trading PLC and Others*, (Federal High court, Civil File No. 96230, 2003 E.C), Unpublished.
[56] Ali Imanalin, *supra note* 22, at 89.

insurer. The insurer would have to monitor the wealth of the insured and all other shareholders to assess the riskiness of its position [57]. Therefore, insurance should be provided by the company (buying from an insurer) to solve the problem of uncompensated risk transfer to creditors. This is because of the company have lower transaction cost as compared to creditor and shareholder even it have no incentive to do so. Insurance does not avoid all uncompensated transfer of risk but it avoids uncompensated risk transfer only concerning risk covered by insurance policy by transferring the risks to an insurer. Such insurance may create an incentive to engage in risky investments.

8.3 Managerial or Directors Liability

The unlimited managerial liability is also a remedy to reduce social cost and moral hazard caused by limited liability. Concerning managerial liability, Ethiopian law have introduced certain circumstances under which the manager [58] and director [59] become liable for the creditor. Several articles of the commercial code impose liability upon directors to the company, its shareholders, and third persons [60]. The liability is for the acts or negligence of the directors. Also, the director of S.C and the manager of PLC directors may be personally liable for the debts of the company itself [61]. Concerning SC, according to Art 366 of Commercial Code, the director shall be liable to creditor where insufficiency of the company's assets to meet its liabilities arising from its *failure* to preserve the company's assets. Likewise, the manager of PLC is also liable to third parties creditors for any breach of their duties under the commercial code or the articles of association. The manager of PLC is liable to the creditor for breach of duties, whereas the director of PLC is liable for failure to preserve the company's assets. This indicates the unlimited liability of management to the creditor is conditional which is dependent on breach or failure. In case those conditions are not fulfilled, the director and manager have limited [no] liability. Hence, the conditional unlimited liability of management is not sufficient to reduce social cost and moral hazard caused by limited liability. Instead, the limited liability of the manager and director should be granted only when the assets of the company is insufficient to fulfill claims of creditors only because of the factor beyond control. Here, the effect unlimited managerial liability on access to qualified manager or director needs due considerations.

8.4 Minimum Capital Requirement

The minimum capital requirement is another remedy to reduce social cost and moral hazard caused by limited liability. The Ethiopian company law has provided minimum capital requirement which insufficient (50000 for SC and 15000 for PLC) under current economic reality. However, the capital requirement for company which operates as financial institutions (bank, reinsurer, financial leasing company, microfinance, and insurance,) have a relatively better minimum capital requirement [62]. To enable minimum capital requirements to play its role to reduce social cost and moral hazard caused by limited liability, the minimum capital requirement of S.C and PLC under the commercial code should be increased. The flat minimum capital requirement is also not legitimate and economically efficient. Instead, the minimum capital requirement should be made proportional to the equity-debt ratio of the company. Accordingly, the minimum capital requirement should increase with the debt of the company.

8.5 Legal Reserve

The legal reserve is a well-known remedy to reduce social costs and moral hazards caused by limited liability. The Ethiopian company law has recognized legal reserve as a mandatory condition during the operation of the company. Legal reserves are mandatory for both SC [63] and PLC [64]. Moreover, the legal reserve should be deposited in a blocked bank account, which may be withdrawn only upon the approval of the supervisory body. The commercial code is silent about the deposition of legal reserve in a blocked account. The legal reserve should be deposited before profit distribution. In this regard, commercial code is appreciated [65]. To serve its purpose of securing creditor, and reducing social cost and moral hazard caused by limited liability the legal reserve should continue throughout the lifetime of the company up to the amount legal reserve become equal with the total debt of the company. Also, the rate of profit deposited as a legal reserve should have to be efficient. The commercial code is inefficient in this regard. For S.C., the rate of profit deposited as a legal reserve each year should not be less than one-twentieth (five percent) of the net profit until it amounts to one-fifth (twenty percent) of the capital (not asset) [66]. For PLC, the rate of profit deposited as a legal reserve each year should not be less than one-twentieth (five percent) of the profits until such fund amounts to one-tenth of the capital. Based on this, the legal reserve can be deposited only until it reaches one-fifth (twenty percent) and one-tenth (ten percent) of capital (not asset) for S.C and PLC which is insufficient relative minimum capital requirement discussed above. Hence, legal reserve under the commercial code is insufficient and inefficient to compensate creditors and to play its role in reducing social costs.

The regulation of legal reserve for S.C operating as bank, insurer, and micro-financing institution (MFI) is different. Any S.C operating as a bank and MFI [67] shall, at the end of each financial year, transfer to its legal reserve account a

[57] Easterbrook & Fischel, *supra note* 2, at 97.
[58] Commercial Code of Ethiopia 1960, Art. 530.
[59] Commercial Code of Ethiopia 1960, Art. 366.
[60] Commercial Code of Ethiopia 1960, Art. 364-367.
[61] Commercial Code of Ethiopia 1960, Art 366(1).
[62] The minimum paid capital for Share Company which operate as bank and reinsurance is five hundred million birr. The minimum paid capital for Share Company which operate as capital good leasing company is two hundred fifty million birr minimum paid up capital. The minimum paid capital for Share Company which operate as microfinance institution is ten millions birr. The minimum paid capital for Share Company which operate as insurance company is Sixty million birr for general insurance, fifteen million birr for long term insurance and seventy five million for both general and long term insurance. See Licensing and Supervision of Banking Business Minimum Capital Requirement for Banks Directives No. SBB/50/2011, Licensing and supervision of reinsurance business reinsurance company establishment directives no. SRB/1/2014, Minimum Paid up Capital Requirement Directives No. CGFB /01/ 2013, Licensing and Supervision of the Business of Microfinance Instituions Minimum Capital Requirement Directives No. MFI/ 27 /2015, Minimum paid up capital for insurer number SIB/34/2014.
[63] Commercial Code of Ethiopia 1960, Art. 431, 453, 454, 456, 482, and 483.
[64] Commercial Code of Ethiopia 1960, Art. 539.
[65] Commercial Code of Ethiopia 1960, Art. 456(1).
[66] Commercial Code of Ethiopia 1960, Art. 454(1).
[67] Micro-Financing Business Proclamation No. 626/2009, Art. 28(1).

sum of not less than twenty-five percent of its net profit until legal reserve become equal to their paid-up capital [68], whereas any S.C operating as insurer shall at the end of each financial year, transfer to its legal reserve account a sum of not less than ten percent of its net profit until its legal reserve becomes equal to the paid-up capital of the insurer [69]. When the legal reserve of banks, MFI, and insurer become equals to their paid-up capital, the amount to be retained by them as a legal reserve from the net profit each year shall be determined by the directive of the National Bank [70]. Relatively, the legal reserve deposited by S.C working as a bank, MFI, and insurer is sufficient and efficient to reduce the social cost of limited liability. However, it is more efficient if the amount of legal reserve is proportional to debt of the company.

9. Concluding Remarks

A company with limited liability protection for shareholder is the greatest invention ever to make a profit with limited liability. Limited liability foster efficiency and productivity by lowering monitoring and information cost, reducing the risk of investment, ensuring stock market operation and free transferability of share, encourage entrepreneurship and investment, and diversification thereof. On the other side limited liability create social cost and moral hazard by externalizing risk of business failures to company's creditor and create an uncompensated transfer of risks to a creditor (especially tort creditors), serving as mean of liability evasion and canceling real interest behind the business, and giving an incentive to risky investment. The difference between limited and unlimited liability is minimal in the case of PLC. To conclude, limited liability have benefit and costs. However, the benefit of limited liability outweighs its costs. The rule should be designed in a manner enabling to reap the benefit of limited liability and reducing costs of limited liability to the shareholder, creditors, and other stakeholders. Accordingly, mandatory insurance, managerial liability, veil piercing doctrine, minimum capital requirement, and legal reserve should be made functional with limited liability to reduce the social cost and moral hazard and thereby increase the overall economic efficiency of limited liability.

Based on these concluding remarks. First, to improve the economic efficiency of limited liability by reducing its social cost unlimited liability of management, stock market, minimum capital requirement, legal reserve, corporate governance code, mandatory insurance, financial reporting duty, and veil piercing shall be introduced based on economically sound principle. Second, concerning tort creditors, unlimited liability is an economically efficient rule. Hence, unlimited liability shall be introduced concerning the claim of tort creditor. Alternately, it is possible to introduce mandatory insurance coverage to ensure fair compensation for tort creditors. Third, concerning SC limited liability is an efficient rule. Accordingly, the limited liability rule for share companies shall be maintained. Fourth, concerning PLC, the difference between limited and unlimited rule on its productivity and transaction cots is minimal. Thus, unlimited liability rules shall be introduced for PLC to minimize the social cost of limited liability.

[68] Banking Proclamation, Banking Business Proclamation No. 592/2008, Art. 19.

[69] Insurance Business Proclamation No. 746/2012 Art. 21.

[70] Banking Business Proclamation, Art 19 (3); Micro-Financing Business Proclamation, Art. 28(1); Insurance Business Proclamation, Art. 21(3).

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