

# Separate legal entity doctrine and its exceptions

## Structure

1. Separate legal entity doctrine
  - **Salomon** case
2. Exceptions to the separate legal entity doctrine
  1. Company is formed for the sole and dominant purpose of evading a legal obligation
  2. Fraud
  3. Agency
  4. Breaching director's duties
  5. Insolvent trading

## The definition of the separate legal entity doctrine

- Section 124(1) of the *Corporations Act*- A company has legal capacity and powers of an individual
- **Salomon v Salomon & Co Ltd [1897]** reinforces the separate legal entity doctrine, that the company is its own legal person and that the **liability of shareholders is limited and that the shareholders have been protected**
  - **Issue: What is the separate legal entity doctrine?**
  - **Facts:**
    - In 1892, Salomon set up a company under the 1862 Companies Act. Prior to this, he had operated his business for 30 years as a sole trader. Seven shareholders were Mr S, Mrs S and 5 smaller S's. Each took 1 share. Mr S is the managing director and 2 sons were directors (board). The company purchased the business for \$1000 cash \$10,000 in debentures, 20 000 shares and payment of debts worth \$8000 (\$29,000 was an excessive price for its value)
    - Mr S held 20 001 shares, and debentures (secured loan-a right to be repaid this money in the future)
    - Soon after, Salomon took a loan from Broderip of \$5000 who took an interest in the secured loan (debentures)
    - The company collapses, and there is a \$11,000 debt and assets of \$6000
    - The liquidator argued that Mr S not entitled to payment (as a secured creditor/shareholder) as the company was really a one person company and Parliament did not intend to give protection in situations like this.
  - **Rule:**
    - Recognised and affirmed the separate legal status of a company.
    - A person's liability could be limited to the amount they had promised or contributed to the capital of a company. Thus, this means that shareholders of the company cannot be called to contribute to the debts of the company beyond any amount they owed on their shares. (reflected in s516 CA)
  - **Decision:**
    - The company is a separate legal entity and there is a 'corporate evil' between it and its shareholders.
    - Therefore, as there is limited liability, Salomon could not be pursued personally for the debts of the companies.
- **Lee v Lee's Air Farming Ltd**
  - **Issue: Is the company a separate legal entity? Can an individual be an employee and director?**
  - **Facts**
    - Mr Lee was the only director and held all shares to a company except one. Mr Lee was killed in an accident whilst performing a job for the company. The wife took out the insurance, but to be successful, Mr Lee needed to be 'a

worker or any person who has entered into works under a contract of service with an employer.' The company raised the objection that Mr Lee could not be a worker and employer at the same time.

- **Rule**
  - As held in *Salomon*, one person may function in dual capacities
  - The company is a separate legal entity and its sole director/shareholder can also be an employee who entered into a contract with it
- **Andar Transport Pty Ltd v Bramble**
  - **Issue: Can you apply the separate legal entity doctrine to 'one person' companies?**
  - **Facts:**
    - Wail injured his back whilst working for Brambles, and sued him for contributory negligence.
    - However, as Brambles was a one person company, he could only be sued for liability as a company in this case.
    - The extent to which Andar owed Wail a duty of care differs between an individual and company. Andar owed Wail a duty of care to provide a safe working environment in this case.
  - **Rule:**
    - You apply the separate legal entity doctrine to 'one-person' companies

## Exceptions to the separate legal entity doctrine

- In in the below headings, the courts are willing to disregard the separate status of a company (ie. Pierce the corporate veil) to hold members liable for their actions

## Company is formed for the sole and dominant purpose of evading a legal obligation

- **Gilford Motor Co Ltd v Horne**
  - **Issue: When will liability be enforced under the separate legal entity doctrine?**
  - **Facts:**
    - Horne was employed as managing director of Gilford Moto. There was a provision in his contract that stated if he left the company, he promised not to compete with it or try to solicit (obtain) its customers. However, after he quit, he set up his own company to run a business in competition with Gilford Motor. Gilford Motor sued Horne under the restraint of trade clause.
  - **Rule:**
    - As the company had been formed for the **sole or dominant purpose** of avoiding the restraint of trade clause, both Horne and the company were subject to its terms and an injunction (warning) was issued against both defendants.
    - In the case of Pioneer Concrete Services Ltd did not apply in *Gilford Motor*, as there was not enough evidence on the facts that the company had been formed 'for the sole or for the dominant purpose' of evading a legal obligation
  - **Conclusion:**
    - Horne was guilty, and he was liable for his actions
- **Prest v Petrodel Resources Ltd**
  - **Issue: When will liability be enforced under the separate legal entity doctrine? What is the evasion principle?**
  - **Facts:**
    - Michael Prest was divorcing his wife. He owned several residential properties that belonged to the companies within the Petrodel Group. The group of companies were wholly owned and controlled by Prest.

- **Rule:**
  - Lord Sumption says that at common law, the corporate veil should only be pierced when there is no other legal remedy available, and then only when a person used a company to avoid an existing legal obligation. **This is called the evasion principle.**
  - In other cases, shareholders cannot be personally liable more than what they contributed towards the shares.

## Fraud

- **Re Darby**
  - **Issue: Fraud as an exception to the separate legal entity doctrine**
  - **Facts:**
    - Two individuals, Darby and Gyde, registered a company called CILIC, and use this company register WSQ and sought investments in that company. The money raised through the public sale of shares in WSQ were transferred back to CILIC, and then to Darby and Gyde. When WSQ the company failed, action was taken against Darby and Gyde to recover the profits they had made from the scam.
  - **Rule:**
    - As CILIC had established WSQ, it was the 'promoter' and was liable for any false statements contained in the prospectus (WSQ)
    - However, the Court was willing to put aside the separate legal entity doctrine and impose liability on Darby and Gyde because CILIC was 'a mere alias' (false identity) for Darby and Gyde, who had committed the fraud

## Agency

- If Agency can be shown, whereby a company can act as an agent for its controller, then this can be an exception to the separate legal entity doctrine.
- **Salomon [1897]**-the House of Lords recognised a company can act as an agent for its controller. However, the mere fact that a particular shareholder owns most of the shares in a company does not create an agency relationship. **For an implied agency relationship to exist, the facts must show that the principal has appointed the company to act on its behalf.**
- **Smith, Stone & Knight Ltd v Birmingham Corporation [1939] 4 ALL ER 116.**
  - **Issue: What is the test for agency?**
  - **Facts:**
    - Smith, Stone & Knight Ltd (SSK) carried on a manufacturing business, purchased a waste business and set up a subsidiary company (Birmingham Waste-BW) to run the business. The Local Council sought to acquire the land on which Birmingham Waste operated-and owned by SSK. The legislation provided that SSK was entitled to compensation as the owned of the land, but BW only had compensation if it was a tenant of more than one year. In this case, BW was not a formal tenant.
  - **Rule:**
    - SSK argued that the waste business was not a separate business from the manufacturing business. It argued that an agency relationship existed between BW acting as an agent of SSK.
    - Agency is a question of fact. Questions considered are [here](#).
    - On the facts, it was shown that the 2 companies operated with almost identical staff, no independent books or bank accounts, and BW's income was SSK's.
    - **Where a company is carrying on behalf of a principal and not its own, the corporate veil will be lifted and the principal will be liable**
  - **Decision:**
    - Separate legal doctrine did not apply and 3 directors were liable.
- **Briggs v James Hardie & Co Pty Ltd (1989) 16 NSWLR 549**

- **Issue: Weakness of agency relationship as an exception to separate legal doctrine**
- **Rule:** Rogers AJA noted that applying the agency relationship to every holding company and fully owned subsidiary could result in so many cases of limited liability in relation to subsidiaries. As a result, the agency argument has rarely been successful in circumventing the separate legal entity doctrine.

## Breaching director's duties

1. S 588G of the *Corporations Act* provides that directors are liable for the debts of a company if they continue to trade after the company becomes insolvent.
  - The effect of this section is to make directors personally liable for a company's debts if, at the time of the debt, there were reasonable grounds for a director suspecting that the company was or would become insolvent, and the director should have been aware of these grounds.
  - Under s 95A(2), a company is insolvent when it cannot pay its debts as and when they fall due for payment
2. **Walker v Wimborne**
  - **Issue: Can directors act in the interests of a group of companies, or do they owe each individual corporate entity something?**
  - **Facts:**
    - There was an action by the liquidator of Asiatic Electric Co Pty Ltd ('Asiatic') against its 3 directors. These 3 individuals were the only directors of a number of other companies. The group of companies experienced some financial difficulties and the 3 directors moved funds between the companies to meet debts as they arose. When Asiatic had become insolvent, the liquidator argued that these payments involved a breach of directors' duties as the payments were not made in Asiatic's best interests. The 3 directors argued they had acted for the benefit for a group of companies to prevent them from going into liquidation.
  - **Rule:**
    - The HC confirmed that directors owed duties to each individual corporate entity they manage, and they cannot act in the interests of a group of companies.
    - Directors who breach their duties can be held accountable for their breaches
3. **Pioneer Concrete Services Ltd v Yelnah**-a parent company having control over a subsidiary is not sufficient reason to justify piercing the corporate veil (aka not following the separate legal doctrine)

## Insolvent trading

- S 588V of the *Corporations Act* makes a parent company liable for the debts of a subsidiary where insolvent trading is involved.
- For liability to attach, there must be reasonable grounds for the parent company to suspect, at the time a debt is incurred by a subsidiary, that the subsidiary company is insolvent.

## Liabilities of companies in tort and criminal law

### Structure

1. Actions of directors/other individuals being attributable to a company
2. Types of liabilities (tort and criminal)
3. Penalties and determining liabilities in Criminal Law

## Attribution of actions to a company

- In the following cases, the actions of directors/board members, or anyone acting for a company can make a company liable. In some cases, the actions of junior employees can be attributable to a company.
- *Pharmaceutical society v London and Provincial Supply Association Ltd*-a corporation cannot be imprisoned, but a corporation may be fined and a corporation may pay damages
- *Tesco Supermarkets Ltd v Natrass* [1972]
  - **Issue: Who is liable for a company's liability in criminal law?**
  - **Facts:**
    - Reduced price product was sold out, and store employee put out same product at normal price. The next day, a customer tried to buy the product at a reduced price, but was told there was no more discounted items left. Customer sued for false advertising.
    - **Rule:** The store manager was not the 'directing mind' of the corporation and therefore his conduct was not attributable for it. In order for the liability of the company to attach to the actions of a person, they must be acting as the company.
      - House of Lords: Normally, the board of directors, the managing director and perhaps other superior officers of a company carry out the functions of management and speak and act as the company. Their subordinates do not.'
- *ABC Development Learning Centres Pty Ltd v Wallace* (2006)
  - **Issue: When are the actions of junior employees (not just managers and directors) attributable to the liability of the company?**
  - **Facts:** ABC was prosecuted for a breach of *the Children's Services Act* 1996 (Vic). The child escaped from the childcare centre owned by ABC, and child was returned unharmed. However, they were prosecuted.
  - **Rule:**
    - Bell J applied principle in *Meridan Global Funds Asia Ltd v Securities Commission*
    - In exceptional circumstances, primary rules of attribution will not provide an answer.
    - The Court must take into account the language of the statute, and its content and policy.
  - **Reasoning**
    - Adopting this approach, Bell J said that the actions of junior employees could be attributable to the company due to the terms of the offence and the policy objectives of the enabling statute
    - In the statute, protection, supervision and care of young children were paramount considerations in legislation.
  - **Decision:** Therefore, the actions of junior employees could be attributable to the company.

## Liability of companies

- **A company can be vicariously or directly liable where it has committed a wrong**
- A corporation can be vicariously liable for the acts or omissions of its employees and agents committed within the course of their employment or within the scope of their authority where such liability is clear on the terms of the particular legislation
- A corporation can be directly liable where it causes or contributes to injury to a person. This is circumstances where a company itself is liable for the wrong ie. Negligence, defamation, deceit, conspiracy, breach of statutory duty.

## Penalties and determine liabilities in Criminal Law

- This refers to the *Criminal Code Act 1995* (Cth)
- S4B-a corporation can be fined

- S12.2-physical element-a criminal offence can be attributed to a company if it is committed by an employee, agent or officer of the company acting within the actual or apparent scope of their employment or within their actual or apparent authority
- S12.3-fault element-an offence can be attributed to a company where it expressly, tacitly or impliedly authorises or permits the commission of the offence.

## The internal rules of a company

### Structure

- 1) Corporate internal governance
- 2) Replaceable Rules acting as the Statutory Contract
- 3) Remedies for breach of a Statutory Contract
- 4) Interpretation of provisions in a Statutory Contract
- 5) Altering the Constitution
- 6) Protection of Class Rights

### Corporate internal governance

- When a company is set up, a decision needs to be made on whether its internal rules will be governed by:
  - Replaceable rules set out in the Act
  - A constitution
  - (s134) or a combination of both
- The persons setting up a company can adopt a constitution either on or after registration
  - Under s 136(1), a Constitution may be adopted at the time the company is registered, provided that beforehand each person who is listed in the registration application as member has agreed in writing to the terms of the Constitution
  - Otherwise, a company can adopt a constitution after registration by passing a special resolution which adopts the constitution
- A replaceable rule will apply in a company automatically unless the company has a constitution which displaces or modifies that rule (s 135(2))
  - A table of replaceable rules can be found in s 141 of the *Corporations Act*
- At least 75% of the members present need to agree for a special resolution to be passed [s 136(2) of the Act
  - It doesn't matter how many shares you have. Members=shareholders, but you need to be present for it. If you are not present, then your vote doesn't count
- An ordinary resolution is where 50% of the shareholders need to agree
- Matters that require ordinary resolution: everyday matters important to the running of a business
- Matters that require special resolution: issue of equity shares, buy back of shares or securities, changing a companies' name, winding up the company (selling assets)

### Replaceable Rules as the Statutory Contract

- **A company's constitution and the replaceable rules are deemed by s 140(1) to have the effect of a contract between**
  1. The company and each member,
  2. Between the company and each director and company secretary, and
  3. Between each member

- When a company has adopted some or all of the replaceable rules, these rules operate as terms of the statutory contract between the company and each member, the company and each director/secretary and between a member and each other member
- The list of contractual relationships set out in s 140 is exhaustive (ie. No relationship between director and member)
  - In *Eley*, third parties are not entitled to enforce the terms of the statutory contract.
- All public companies limited by guarantee without Limited (s 150) and no liability companies (s 112) cannot use replaceable rules. These companies must have their own Constitution.
- A person does not need to read the replaceable rules or the Constitution to be bound by them,
- When one buys shares in a company or takes on a position as director, they're instantly bound by the terms of the statutory contract-*Shuttleworth v Cox Brothers*

#### Alteration of the Constitution

- If the Company has a Constitution, it can be amended by special resolution (75% of members present and voting at meeting s9).
- If normal contracts to be amended, all parties to the contract must agree to the variation
- Under s 140(2), any change to the Constitution made after a person becomes a member that requires them to take up additional shares, increases their liability to the company is not binding unless they agree to the change in writing.

#### What are in replaceable rules/Constitution?

- How general meetings will be held
- How voting rights can be exercised
- Rules regarding the selling of shares

#### Remedies for breach of statutory contract

- Under s135(3), a contravention of a replaceable rule is not a breach of the *Corporations Act*. Whilst the replaceable rules appear in the legislation, they do not attract statutory remedies under the Act
- Common remedies for breach of statutory contract include:

##### 1) Seeking a declaration or injunction

- The most common remedies sought for breach of the Constitution or the replaceable rules is an injunction to restrain the breach and/or a declaration as to the validity of any action
- You can seek an injunction when the action itself has not been carried out yet
- A member, director or secretary commencing an action for breach of the corporate contract must first show that the breach adversely affects them in a specific capacity as a member, director or secretary
- Once this is established, they can seek a declaration or injunction under common law requiring the other party (usually the company) to comply with or refrain from breaching the terms of the statutory contract

##### ○ *Inspector James v Ryan (No 3)*

- **Issue: Are Constitution rules enforceable?**
- **Facts:** Industrial Court NSW had to determine if an appointment of a director was invalid where the provisions of the company's constitution were not complied with. Under the Constitution, replaceable rules were expressly displaced, so the only provision regarding the appointment of a director was under Clause 13.6 which stated that a director, secretary or executive could exercise a power by notice in writing delivered by facsimile or other electronic means to Dekorfom.
- **Rule:**

- It is considered that the appointment of a director is a fundamental exercise of power within a corporation and any provisions in the constitution dealing with the matter had to be complied with if the appointment was to be valid.
- As replaceable rules had been displaced by clause 13.5, it was imperative that 13.6 needed to be followed for the appointment to be valid.

## 2) Specific performance of a provision

- Parties can seek a specific performance order for a payment of a dividend

## 3) Rectification and damages

- The contractual remedy of rectification is not available if there has been a mistake in the wording of the corporate constitution, or the wording does not represent the actual intentions of the members-*Lion Nathan Australia*
- There is ongoing debate about the remedy of damages for breach of statutory contract
- In *MacLaughlin v Dungowan Manly*, the NSWSC granted damages to the holders of shares in a home unit company. The appeal was dismissed, and Bathurst CJ said that there was some doubt as to whether the statutory contract formed by s 140 of the Act gives rise to a claim for damages for breaches.'

## 4) Additional members' remedies under a shareholders' agreement

- Members in a company may enter into a shareholders' agreement, giving them additional rights in contract against each other
- The benefits of this is that it can be created any time after incorporation, it can deal with issues particular to the members in question
- However, a company's constitution cannot be overridden by a shareholders' agreement

## 5) Additional members' remedies under statute

- Members have the following remedies available to them under the *Corporations Act* to protect them from actions by directors or shareholders
  - S 232-oppressive conduct
  - S 461-order to have the company wound up where it is just and equitable to do so, or where directors have acted in their own interest
  - S 246B-246G which is an order seeking to prevent a variation of the rights attached to shares where the constitution is not followed/no procedure existing