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INTRODUCTION

What is a company?

Historical development of the corporate form

UK

- Early boroughs (13C) and guilds (13&14C)

  - After religious groups and offices, second species of corporate person recognized by common law was the borough. Merchants were moving forces behind borough's drive for franchises and privileges.
  - 13&14C: groups of local merchants sought royal charters conferring like privileges on their own number, e.g. to enjoy a monopoly of trade in the commodity produced by the borough, to sue and be sued in the group name, common seal.
  - 15C: recognition of the group as an incorporate body – merchant guilds. With the protection of their charters, comprised an exclusive society of traders enjoying valuable rights. Not vehicles for collective trading activities, but associations of individuals trading for private advantage only. Nonetheless, exercised public regulatory functions in the trading sphere akin to those of the borough in municipal govt. Guild ordinances prescribed the conditions upon which members might trade and the guildcourt exercised jurisdiction in all trade disputes.
  - When trading took on a less provincial cast, the borough merchant guilds gave way to the craft or trade guilds which controlled, not a monopoly of trade in a particular borough, but the whole of a particular trade or craft in a wider geographical region.
  - <u>Summary:</u> Guilds = traders that bounded together with a common interest. Members traded separately. Eventually members wanted incorporation for the guild b/c wanted legitimacy from King. From this came the right to exclude non-members. E.g. Hudson Bay Company, East India Company.
- <u>Incorporation by Royal Charter</u>
  - 'Regulated companies' – a limited purpose guild in which member merchants engaged in foreign trade on their own account and risk, subject to regs passed by the company
    - Charters typically ceded to company not only trading privileges but extensive powers of self-govt in region such as power to make laws, raise taxes, establish a currency, conduct wars and settle the peace. Dutch East India Company established a trading empire extending from Java to Japan, Sri Lanka and South Africa which it relinquished to Crown only at end of 18C.
    - Charters also granted to domestic trading concerns, usually large partnerships alert to the benefits of incorporation.
  - By 2nd half of 16C, guilds had broken down as a system for regulating industry – navigational advances, fund of capital available for investment emerging among wealthy mercantile class, fraternal and egalitarian values compromised by oligarchic tendencies
- <u>Incorporation by Private Act of Parliament</u>
  - 'Statutory companies'
  - From outset, incorporation by private statute reserved for ventures of a public nature, albeit pursued for private profit or requiring extended financial responsibility (such as insurance) or attended by special risks (such as foreign mining ventures). This continued until grant of general incorporation rendered the procedure otiose.
- <u>The rise of joint stock companies</u>
  - De facto incorporation via deed of settlement – i.e. mimicked the benefits of regulated and statutory companies. By this device the prohibitions of the Bubble Act were effectively circumvented.
  - Not companies themselves – were in fact large partnerships.
  - Regulated and statutory companies traded individually – joint stock companies traded together w/ joint stock.
  - Economic factors in 18C made it imperative that a form of business association be available to facilitate the aggregation of investment capital. E.g. Expansion of foreign trade, industrialisation, growth of factory system.
- <u>Bubble Act 1720</u>
  - Enacted during one of worst financial bubbles in history. UK govt in debt.
  - Govt approached South Sea Company, which financed debt in exchange for 6% interest. Govt said it could have exclusive trading rights with the south seas. Benefits of this investment extended to all companies, including joint stock companies. South Sea Company not pleased b/c it had gone through red tape to become a regulatory company.
    - This scheme would succeed only if South Sea's share price rose so that the cost of conversion of debt was reduced. From Feb to August 1720, the market price of the company's shares rose from $129 to over $1,000.

        - The boom South Sea had fanned extended beyond the company's stocks.
    - Bubble Act designed to outlaw joint stock companies. Prohibited a company from acting or presuming to act as a corporation and from raising a transferable stock w/o sanction of legislation or charter.
- Repeal of Bubble Act in 1825
    - Act was massive disaster – difficult to prosecute joint stock companies based on its enforcement provisions. Didn't protect companies like South Sea Company – it provoked market panic (stampede). Shares fell back to $129. Joint stock companies popular.
- Joint Stock Companies Registration and Regulation Act 1844
    - Permitted statutory incorporation of joint stock companies as a right. Monarch or Act of Parl no longer needed to give right to incorporate – just had to pay fee and fill out form.
    - Established accountability mechanisms – holding of company meetings, audit of accounts
- Limited Liability Act 1855 – liability limited to amount contributed
- Companies Act 1862
    - This is where Australia leaves UK – brought into Australia
    - Didn't really change until England entered EU

Australia

- S 51(xx) of Constitution gives Cth a limited power to make laws with respect to: 'foreign corporations and trading or financial corporations formed within the limits of the Cth'
- 1901-1950: Separate State Acts – difficult for companies wanting to operate in different states
- 1961-1963: Uniform Companies Act 1961
    - Each State and territory implemented the Victorian legislation
    - Problems: no Cth involvement; reviewed and administered at State level; inconsistency led to stock market becoming unpredictable; issues w/ investor protection
- 1978-1991: Co-operative Scheme: Companies Code 1981
    - Didn't involve referral or surrender of State powers but rather the adoption by States of legislation enacted by Cth for the ACT
    - Problems: inconsistent decisions at State level, administrative duplication, poor funding
- 1989: Corporations Act 1989
    - Cth covered the field – legislation covered both incorporation and regulation. States and territories agreed. Had a national regulator.
    - Successfully challenged in NSW v Cth (1990) → Cth has no power over incorporation. Power to legislate for registration of corporations belongs to states.
- 1990: Alice Springs Agreement – new solution
- 1991: Corporations Law 1991
    - Cth law continued to be limited in its reach to ACT and was applied as the local corporations law by each state and NT. However, was constructed to appear as if it was a single national law applying throughout Australia.
    - National regulator operating through State delegates replaced with a single regulator, ASIC, with sole responsibility for administration and enforcement of corporations law
- 1999-2000: Constitutional challenges to the Corporations Law 1991
    - *R v Hughes* (2000)
        - Facts: Challenge to Cth DPP, not validity of legislation.
        - Held: State legislation might validly confer power and functions upon Cth officers (such as Cth DPP) re prosecution of offences under State law only where Cth Constitution would permit Cth Parliament to create offences under Cth law in relation to those matters. I.e. Valid head of power for every action brought to court must be identified for Cth DPP to validly do this.
    - *Re Wakim; ex parte McNally* (1999)
        - Facts: Challenge to cross-vesting powers.
        - Held: State application legislation under the corporations scheme that purported to vest state judicial power in the federal court was invalid. Federal court does not have jurisdiction to determine a matter arising under the Corporations Law of a State.
            - While Constitution provides in s 77(iii) for the "autochthonous expedient" of permitting Cth Parliament to invest State courts with federal jurisdiction, it

contains no mirroring provision authorising federal courts to be invested with jurisdiction under state law.
    - NB: Shortly after case, states passed legislation to validate past decisions of Federal Court in purported exercise of State jurisdiction under their Corporations Law by declaring them to be judgments of the State SC.
  - I.e. *Re Wakim* holds cross-vesting of jurisdiction invalid, and *R v Hugh* raises serious doubts over the power of administrative agencies.
- 2000: Inter-governmental reference agreement
  - All states referred powers under s 51(xxxvii) to enable Cth Parliament to legislate with respect to corporations, corporate regulation and the regulation of financial products and services. I.e. states handed over every power of incorporation to Cth.
  - Caveat: 5-year sunset clause. This has been perpetually renewed.
- 2001: Corporations Act 2001
  - Jurisdiction to determine civil matters arising under the corporations legislation is vested in the FC, in SC of each State and Territory, and Family Court: ss 1337B, 1337C.
  - Re criminal jurisdiction, the several courts of the States and Territories exercising jurisdiction with respect to the summary conviction of offenders have equivalent jurisdiction with respect to offences against the corporations legislation: s 1338B(1)
  - Re indictable offences, the courts of a State or Territory have jurisdiction only with respect to offences committed outside Australia or offences committed, begun or completed in that jurisdiction: s 1338B(8)

Theories and conceptions of the corporation

- NB: It's been left to courts to determine what is a company. Look at a shareholder v stakeholder model.

Concession or privilege theory

- Corporation as an artificial legal entity whose privileges have been granted by state. Corporation can't operate w/o state's permission.
- Criticism: outmoded. It's now an administrative right to operate like this. It's effectively private rights. State's involvement is limited to the enforcement of those private rights.

Contractual/aggregate theory

- Corporation is an artificial entity, but it's nothing more than a convenient means of organising individuals. I.e. means of organising a complex web of contracts.
- This is the economist view of the firm. Dominant theory.
- State's role is the enforcement of contracts. Should be no mandatory rules – just a set of default rules. Corporate law is permissive and supplementary.
- Shareholder primacy b/c are ultimate risk bearers (their financial claims are postponed to those of creditors in winding up), are entitled to surplus income during firm's life, and monopoly of voting rights.
- Inherent in all contractual arrangements is a divergence in interest b/w principal and agent since agent's personal utility will rarely be identical with principal's. Corporation is optimal firm structure since it achieves greatest reduction in agency costs. When managers offer corporate securities, a sceptical market will bid down price of those securities upon capital markets, and make managers bear risk of their shirking and disloyalty, unless managers offer sufficient monitoring and bonding structures to obviate this risk.

The corporation as a 'real' entity: corporate realism

- Corporation is a distinct entity with a 'life of its own'. It's appropriate that criminal liability and sanctions be imposed on the corporation itself. Corporation also has rights – but still uncertainty re this aspect.
- *Burwell v Hobby Lobby Stores* (2014) [NB: only case lecturer knows about]
  - Closely held company = the directors and managers who make all strategic decisions are also the shareholders. Often family companies.
  - Facts: Local regs said companies are required to provide female employees with no cost access to contraceptives. CEO challenged validity on behalf of the company – said violation of its religious rights under Religious Freedoms Act.
  - Held: Company won.

- Team production model
  - Public corporation = team of people who enter into a complex agreement to work together for their mutual gain. They agree not to specific terms or outcomes (as in a traditional contract), but to participation in a process of internal goal setting and dispute resolution.
  - Directors are trustees for corporation itself – mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy
- Communitarian theory
  - Addresses threat of harm to non-shareholders from exclusive management focus upon shareholder interests. Multifiduciary obligation – a duty owed by corporate managers to all stakeholders in the company and not merely to shareholders.

Policy concerns

- For whom should managers of public companies manage?
  - S 181 requires managers of companies to act in good faith in the best interests of the company. What does this mean?
  - Current shareholders? Future shareholders? Employees? Members of public? Creditors? Shareholder v stakeholder approach? Corporate social responsibility?
  - Australia operates on a shareholder model – economic, tangible, justifiable. This is the economist approach. Directors can be justified in thinking about other groups, as long as they can link this back to shareholders and the benefits of the company. E.g. in long term, good for investors.

Types of companies

- The share capital fund
  - Share capital = amount, in money or in money's worth, which members agree to contribute permanently to company in their capacity as members to fund the joint enterprise or activities
  - On winding up, the holders of share capital are the lowest ranked claimants upon the assets of the company; only after creditors have been paid are those who have contributed share capital entitled to have it returned to them. They're also entitled to participate exclusively in any surplus of assets after creditors are paid and the share capital is returned to its holders.
- Shares in the company
  - Share = a proportionate interest in the net worth of the business or undertaking of the company. It confers an interest in the company through a bundle of rights to participate in the financial distributions made by the company and in group decisions.
  - Issued capital = aggregate of amounts of money that members and those applying for membership and those applying for membership have paid or agreed to pay
- Corporations
  - → Companies registered under the *Corporations Act* (s 112(1))
    - Public companies
      - Limited by shares
      - Limited by guarantee
      - Unlimited with shares
      - No liability
    - Proprietary/private companies
      - Limited by shares
      - Unlimited with shares
  - → Other corporations (e.g. incorporated associations; statutory corporations)

A. Classification according to liability (CA ss 9, 112)

- Company limited by shares (public or proprietary)
  - 'a company formed on the principle of having the liability of its members limited to the amount (if any) unpaid on the shares respectively held by them' (s 9)
  - Most popular; equity finance: issue shares for money
- Company limited by guarantee (public only)

  - 'a company formed on the principle of having the liability of its members limited to the respective amounts that the members undertake to contribute to the property of the company if it is wound up' (s 9)
  - Has no share capital. It may require fees to be paid by members or may raise loans but prima facie it is not a convenient vehicle for a business needing working capital. This is why it's unpopular.
  - Often used for non-profit activities such as clubs and community associations that don't require significant funds but seek the protection of limited liability or the advantages of incorporation. Principle drawback is expense and difficulty involved in drawing up a constitution, registering the company and continuing obligations.
- <u>Unlimited liability company</u>
  - 'a company whose members have no limit placed on their liability' (s 9)
  - If company is wound up, and sale of assets is insufficient to meet liabilities, liquidator can make a call to each member to make the difference.
  - Advantage: under law on maintenance of a company's share capital, a company may only reduce its share capital pursuant to a formal approval mechanism. But this class of company is exempted: s 258A. They are structured so that investors may redeem their investments, which take the form of shares in the mutual fund company, simply by having company buy back their shares.
- <u>No liability company (mining – public only)</u>
  - 'a company that is registered as, or converts to, a no liability company under this Act' (s 9)
  - S 112(2) A company may be registered as a no liability company only if:
    - (a) the company has a share capital; and
    - (b) the company's constitution states that its sole objects are mining purposes; and
    - (c) the company has no contractual right under its constitution to recover calls made on its shares from a shareholder who fails to pay them
  - All members must hold shares but members are not liable to pay any calls on their shares. If the directors make a call on the shares, the members can choose whether to pay or not.
  - NB: All the big mining companies we know aren't these companies.

B. Classification according to size (CA ss 45A, 113)

- The 'company' structure and legislation was designed for large companies, needing large amounts of $ from an investing public, where division exists b/w ownership (shareholders) and control (management).
  - Company must prove that they're as small as possible b/c they'll have less obligations if so
- A company which is not a proprietary company is a public company (s 9)

	Proprietary (pty ltd)	**Public (ltd)**
Shareholders (s 45A(1), note 2; s 113)	1 shareholder max. 50 non-employee	1 shareholder no max.
Members s 114	1 member min.	1 member min.
Directors s 201A	1 director (1 resident)	3 directors (2 resident)
Finance s 45A(1), note 2; s 113	Difficult to get sufficient funds from the public	Can get funds from the public (with disclosure document)
Listing s 45A(1), note 2; s 113	Can't be listed	Can be listed or unlisted
Type s 45A(1), note 2; s 113	Limited by shares; unlimited with shares	-

- A proprietary company is small if it satisfies at least 2 of 3 criteria in s 45A(2):
  - (i) The consolidated gross operating revenue for the financial year of the company and any entities it controls is less than $25 million;
  - (ii) The value of the consolidated gross assets at the end of the financial year of the companies and the entities it controls (if any) is less than $12.5 million;
  - (iii) The company and any entities it controls have fewer than 50 employees.
- A proprietary company is large if it is not small: s 45A(3)

C. Classification according to listing (CA ss 45A, 112-116; Part 1.5 "Small Business Guide")

- Companies classified according to their public status
  - → Public company
    - → Listed (shareholders have access to a liquid market)

- → Unlisted (public company has choice to be listed or not)
    - → Proprietary
        - → Small proprietary company
        - → Large proprietary company

Corporate constitution and organs

- 1998: requirement to have a constitution abolished. In place of the memorandum and articles of association, Act introduced a series of provisions which any company may use to regulate its internal proceedings and management – named as a "replaceable rule" or a "replaceable rule for proprietary companies and mandatory rule for public companies": s 135.
- Companies have 3 options re choice of rules to govern their internal management:
    - 1. Function w/o a constitution, relying solely upon the replaceable rules
    - 2. Adopt own constitution to displace or modify the replaceable rules wholly or in part (s 136). Constitution will displace the application to the company of any inconsistent rules except, in case of public company, a rule which is expressed to be mandatory and which operates therefore as an ordinary provision of the Act for the company.
    - 3. If incorporated prior to 1/7/1998, it may retain its memorandum and articles of association as the constitution of the company to the exclusion of inconsistent replaceable rules. If company is a public company, those provisions of the Act which contain a mandatory rule for public companies also apply to them: s 135.

Corporate groups

- "holding company", in relation to a body corporate, means a body corporate of which the first body corporate is a subsidiary – i.e. at the top of the food chain
- S 46: A body corporate (in this section called the first body) is a subsidiary of another body corporate if, and only if:
    - (a) the other body:
        - (i) controls the composition of the first body's board; or
        - (ii) is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of the first body; or
        - (iii) holds more than one-half of the issued share capital of the first body (excluding any part of that issued share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital); or
    - (b) the first body is a subsidiary of a subsidiary of the other body.
- Corporate group: "a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control" (*Walker v Wimborne*)
- Reasons why corporate groups form/evolve:
    - Consequence of company takeovers following the acquisition of all or a majority of the shares of another company; taxation and stamp duty law favour this mode of acquisition over the purchase of assets of the acquired business
    - To achieve organisational efficiencies by segregating different businesses or functions into separate companies
    - To maximise benefits of limited liability by isolating risk of business failure in a single entity
    - In the case of partly owned subsidiaries, to obtain control of another entity and access to its resources w/o cost of acquiring all of its share capital
- Each company in a group retains its distinct entity status with its own separate liabilities and assets. Issues of legal policy include:
    - Whether generally or in particular contexts company law should treat the group itself as the relevant legal entity by ignoring the separate entity status of individual members of the group;
    - What loyalty, if any, should directors of a member company of a group be entitled to extend to the interests of the group as a whole or of other companies in the group, at the expense of their own company's interests;
    - Whether the group controllers owe a duty of good faith and fair dealing towards outside minority shareholders in the group companies and what the content of that duty might be;
    - When the controlling company in the group is liable for the debts of an insolvent member; and

    - Whether there should be a pooling of assets and liabilities in the liquidation of a group of companies

Key bodies in Australian Corporate Law:

- Australian Securities and Investments Commission (ASIC) - chief responsibility
    - Responsible for legislative implementation and administration of CA
    - Goals: maintain performance of companies, the markets in which their securities trade and the confidence of their investors, and to administer and enforce the corporations legislation
    - Extensive powers to investigate breaches of national law, take civil enforcement action, initiate criminal prosecutions and exercise some adjudicative powers
    - ASIC Act seeks to preserve ASIC's independence
- Australian Prudential Regulatory Authority (APRA) – chief regulator of financial institutions in Australia
    - Responsibility for prudential regulation (that is, oversight of capacity to honour financial commitments) of the financial sector (viz, banks, insurance companies and superannuation funds)
- Australian Securities Exchange (ASX)
    - 1998: members of ASX voted to convert it from a mutual organisation of stockbrokers to a public company limited by shares. ASX simultaneously admitted to own Official List so that shares in ASX might be purchased and traded upon the stock market conducted by ASX itself. Dual character:
        - 1. As a body given statutory approval to conduct a stock market, has extensive powers and obligations as a market regulator
        - 2. As a commercial enterprise conducted for the benefit of its shareholders, it charged fees from listed entities for initial and continuing listing and for transactions effected upon its markets
    - 2010: transfer of ASX's supervisory functions to ASIC. ASX retains responsibility for ensuring that companies admitted to its list comply with the listing and operating rules it has promulgated.
    - Pros of listing and quotation upon a securities exchange:
        - Easier for companies to raise funds through new issue facilities of securities markets
        - Secures liquidity for corporate securities which enhances the appeal of the security to investors and thereby facilitates the raising of further funds
        - Enables proprietors whose capital has been effectively locked up in illiquid shareholdings to realise the value of their investment through the market for the shares once they are granted quotation by the stock exchange
        - Promotes investor confidence through monitoring of trading in securities and reduces transaction costs through its standard-form governance and transaction settlement rules
        - Admission to the list conveys a valuable reputational signal
    - Cons:
        - Exposes its controllers to threat of loss of control through takeover if they have used the listing to dispose of a significant portion of their holding
        - Suffer loss of privacy through their continuous exposure to the stock exchange, market and press inquiry as to price-sensitive company developments
        - Subject to considerable expense for listing fees, share registry, annual reports to shareholders and general investor relations
        - Greater regulation of conduct through higher governance standards and trading restraints imposed through the listing rules
- Takeovers Panel (The Panel)
    - Powers conferred by ASIC Act or CA; took jurisdiction away from court re takeovers offences
    - Only such powers presently conferred are those relating to declarations that an acquisition of shares or other conduct (generally but not exclusively made re company takeovers) unacceptable
- Australian Accounting Standards Board (ASB)
    - Established under Pt 12 of ASIC Act to make accounting standards subject to the oversight of the Financial Reporting Council: ss 225, 226
- Financial Reporting Council (FRC)

Administration of Australian companies

Why form a company?

- Legal forms for business
    - Sole trader – liable for own debts; operate in own business name; to sell business, have to get creditor consent to transfer their liabilities; no formalities for formation, conduct, transfer or termination unless a business name is used requiring registration or the solvency of the trader is impaired in which latter case the general bankruptcy law applies; all income received is taxable on an individual basis and only modest opportunities for tax minimisation
    - Joint venture – bunch of people do stuff together with a common goal; occurs a lot of the time in mining; document called 'heads of agreement' governs their relationship
    - Partnership – partners are liable for each other's liabilities; Partnership Act preserves the partnership if one partner leaves
    - Company
    - Trust – trustee given piece of property to preserve it and take care of it for someone else
- Legal forms for charity/non-profit
    - Unincorporated association – people do stuff together, but not for profit; if for profit, would be partnership; uncertainty as to who owns property; all governed by contract
    - Incorporated association – simple and cheap way of running a company, but usually for charity; not governed by Corporations Act, but individual state acts; if want to operate in multiple jurisdictions, have to operate under Corporations Act
        - Deficiency: exposure of committee members to personal liability for the contracts and torts of the association. Members are not, by reason only of their membership, liable to contribute to the discharge of the association's liabilities (i.e. limited liability for corporate obligations): s 26 (Associations Incorporation Act 2009 (NSW).
        - Must not conduct its affairs so as to provide pecuniary gain for its members: s 40
    - Company
    - Trust – most appropriate means to regulate non-for profit
- Factors involved in choosing a legal form of business
    - Separate legal entity
    - Taxation – company must pay company tax rate
        - Dividend imputation provisions introduced in 1980s eliminate the double taxation of company dividends. Companies which have paid tax on their profits at company tax rate may pay dividends to shareholders which carry tax credits at this rate.
    - Costs of formation and continuation
        - Company's status is unaffected by death of bankruptcy of a member or transfer of ownership interests. By contrast, such events will automatically dissolve a partnership and, although "continuation" provisions in partnership agreement may provide for automatic novation by surviving partners, property adjustments usually necessary.
        - Partnership: no formality required for its creation; internal structure not constrained by statute; no registration or reporting obligations. Partners may freely withdraw their capital from firm which may be dissolved w/o formality.
        - Cf incorporation: an act of the state, attended with formality and expense
    - Size
    - Duration
    - Secrecy – company has disclosure obligations (for benefit of creditors, members and, in some cases, the wider community)
    - Liability
    - Transferability of interest
    - Finance options – companies can raise share capital and obtain debt. Have power to create a floating security over its assets (now called a circulating security interest under PPSA) or make a public issue of its shares or debt interests. Sole traders must provide their own capital or borrow.
    - Decision-making structure

How do you form a company?

- Incorporation by registration – CA, ss 117-123

- S 117: to register a company, must lodge an application with ASIC
- S 1274(7A): certificate of registration is conclusive evidence that:
  - (i) all requirements for registration under the Act have been met;
  - (ii) the company was registered on the day specified in the certificate
- S 119: a company comes into existence as a body corporate at the beginning of the day in which it was registered

CORPORATE PERSONALITY AND LIMITED LIABILITY

The doctrine of corporate personality

- CA ss 112, 114, 119, 124, 125, 201A
- Corporate personality – the ascription to the corporation (as distinct from its office or members) of criminal responsibility for activities undertaken by or on behalf of the organization
- Corporation is invested with an entity status, a personhood, distinct from that of its members

Concepts of separate corporate personality and limited liability

- Benefits of limited liability
  - Rational response to division b/w ownership and control
  - Enhances efficiency of capital markets by free transferability of shares (more likely to hand over cash and take a gamble)
  - Encourages portfolio diversification (no monitoring costs; invest in multiple companies)
  - Permits accumulation of large amounts of capital
  - Encourages benign risk-taking by managers (directors aren't trustees and meant to grow business)
- Downsides of limited liability
  - Can encourage excessive risk-taking by directors
  - Is often a fiction – can have small incorporated companies; but those who manage it on a day-to-day basis are the members; it's essentially individuals operating in a corporate form
  - Creditors are better risk bearers than shareholders. Creditors can bargain either for protection (guarantees) or build risk into return demanded.
- *Salomon v Salomon and Co* [1897] AC 22
  - Facts:
    - Mr Salomon ran a leather business as a sole trader.
    - Set up a company with 20,007 shares: he held 20,001 and his wife and 5 children, 1 share each [UK company law at this time required 7 subscribers on incorporation].
    - He sold the business to the company for shares and cash.
    - A balance of $10,000 remained payable to Mr Salomon.
    - Mr S secured payment of the $10,000 debt through the issue of debentures (loans) secured by a floating charge covering all assets of the company.
    - He was the majority shareholder and the primary creditor (owed $10,000 under the debenture) when the company was wound up.
    - The asset sales were less than $10,000 and the unsecured creditors received nothing.
  - Issue: Should Mr S's secured debt of $10,00 take precedence over the unsecured creditors? Can the creditors have recourse to Mr S himself?
  - Argument:
    - 1. The company was a mere agent or alter ego of Mr S and thus Mr S was liable for the company's debts.
    - 2. The debentures issued to Mr S were invalid on the basis of fraud.
    - 3. The transfer of the business was said to be on the basis of fraud.
    - 4. Alternatively, the liquidator claimed $20,000 for Mr S's shares on the basis that he had paid nothing for them.
  - Held (HoL): A Salomon and Company is a separate legal entity to Mr S. Act says 7 subscribers – doesn't say 7 independent subscribers. Company has 7.
    - Mr S has formed himself a valid company, which is separate to him, as a member. He does not owe the unsecured creditors. He is the secured creditor, and gets paid out first.
  - Principle: A company exists as a separate legal entity – separate to its members and its directors.