

Seminar 4: Some consequences of corporate personality. 170-235

LIMITED LIABILITY

The nexus between corporate personality and limited liability

The idea of a company is that it has a separate legal personality to its members or directors. Corporate personality and limited liability are closely linked.

- **Corporate personality** serves the function of marking out an asset pool against which creditors of the enterprise have prior claims - the fact that the company has a separate identity partitions this asset pool from the personal assets of stakeholders
- **Piercing the veil typically involves breaking the partition to expose the personal assets of shareholders (s/h) and directors to the claims of the firm's creditors**
 - Absent such circumstances, shareholders and directors are not liable for the debts of the corporation.
- The recognition of corporate personality is thus closely tied to the limited liability doctrines - the recognition of the corporation as an entity whose rights and duties are distinct from those of its members and directors is a precondition to the limited liability that members of most types of registered company enjoy.

The merits and costs of limited liability

The main purpose behind limited liability was to protect investors in publicly held companies. In the context of today's climate (where most companies are small private companies where the shareholders and directors are pretty much the same people), some would argue that the benefits to shareholders are matched by risks to creditors.

- **Merits:**
 - Encourages investment by those who have no interest in/capacity for management participation.
 - Relieves shareholders from the burden of monitoring fellow shareholders' capacity to contribute proportionately to company failure under a regime of joint and several unlimited liability.
 - Encourages free liquidity of share capital, which not only reduces the cost of capital to the company, but also insinuates an accountability mechanism for management through the threat that poor performance reflected in stock price decline will stimulate the acquisition of control by a party which believes it can achieve superior returns through management replacement.
 - Encourages entrepreneurial risk taking by companies since they may safely invest in projects with prospects of positive returns but also those with significant risk exposure. If projects with higher risk profiles are conducted through a separate entity, that further insulates members from losses.
- **Risks:**
 - May create a moral hazard in the area of tort law with the opportunity it offers to externalise the risks of enterprise.
 - Favours the externalisation of social costs of corporate behaviour, shifting the risk of enterprise operations away from shareholders and onto stakeholders or wider society.
 - Mainly moral dilemmas - individual moral restraint is often blurred by the demands of the corporate role and lost in the anonymity of group decisions and action.

Corporate personality

The special character of corporate personality

A company registered under the Act is invested with the legal capacity and powers of an individual (s 124) though its incorporeal nature ensures that it enjoys perpetual succession in the sense that there is no temporal/change of membership limit upon its existence.

- It can commit both **crime and tort**.
- Injury to its reputation can be sued for by a defamation claim, although it may recover only injury to its pocket and not its feelings: *Lewis v Daily Telegraph* [1964], *Mirror Newspapers Ltd v Harrison* (1983). (**company can sue and be sued**)
- It can be held in contempt of court: *R v J G Hammond & Co* [1914], but it is incapable of personal appearance and must appear through a representative: *Tritonia Ltd v Equity and Law Life Assurances Soc* [1943]
- Not entitled to invoke the common law privilege against self-incrimination in answer to a demand for the production of documents under statutory power: *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993).
- Reference to “person” in state and commonwealth legislation refers also to a body corporate unless contrary intention expressed: *Acts Interpretation Act 1901* (Cth) s 22 and *Interpretation Act 1897* (NSW) s 21(c).
- “Residents” in s 75(iv) of the Constitution does not embrace corporations: *Australasian Temperance and General Life Assurance Society Ltd v Howe* (1922)
- Protective provisions in a money lending statute have been interpreted as confined to the “protection of borrowers who are natural persons and subject to the possibility of being overreached in their indigence”: *Motel Marine Pty Ltd v IAC (Finance) Pty Ltd* (1964)
- It is well established that a company may be an enemy alien, its status being determined by the nationality of those persons in control of its affairs: *Daimler Co Ltd v Continental Tyre and Rubber Co Ltd* [1916]
- A company can own property: *Macaura v Northern Assurance Co Ltd* (1925)
- A company can enter into contracts itself (s 127) or through its agents (s 126).

The separate personality of the corporation

The modern conception of a separate legal entity and limited liability were established in the **landmark case of *Salomon v Salomon & Co Ltd* (1897)**:

Facts:

- Mr Salomon had a business selling boots and at one point he made it into a company with his 6 family members making up the other shareholders (7 was a minimum in those days).
- Those relatives were nominal shareholders and Mr Salomon held basically all shares. He also massively overvalued the company.
- The business eventually went bankrupt and had a few creditors including two secured creditors (one of them actually being Mr Salomon himself).
- The liquidator was trying to get money back from Mr Salomon on the basis that the company was really a fraud – it was really just an agency for Salomon to reduce his liability.

Judgment:

- The Court reject the arguments of fraud and agency - there was nothing in the Act about whether the shareholders should be independent of the majority shareholder.
- The company was **duly constituted in law** and it was not the function of judges to read into the statute limitations.
- The **company was thus a separate legal entity and there is a 'corporate veil' between it and its shareholders - they are limited in liability and Salomon could not be pursued personally for the debts of the companies.**
- Lord Halsbury stated: "...once a **company is legally incorporated** it must be treated like any other **independent person with its rights and liabilities** appropriate to itself, and that the motives of those who took part in the promotion of the company are obviously irrelevant in discussing what those rights and liabilities are.

Consequences: Company is a legal entity separate from its participants. The benefits of incorporation were extended to small private companies

Lee v Lee's Air Farming Ltd (1961): Capacity to enter into contracts

Facts:

- Lee had a company in which he held all of the issued capital except for one share held by his solicitor. He was also the governing director of the company and was employed at a salary as its chief pilot. Effectively, he controlled affairs of the company
- He was killed while performing a job for the company. The company, pursuant to legislation, had taken out workers compensation cover on its employees and his widow sued for compensation as the widow of the "worker", defined in the statute as "a person who works under a contract of service with the employer".
- The NZ Court of appeal rejected the claim on the basis that since Lee fully controlled the company, he could not also be its employee. This was appealed to the Privy Council.

Held:

- "The mere fact that someone is a director of a company is no impediment to his **entering into a contract to serve the company**. If, then, it be accepted that the respondent company was a legal entity their Lordships see no reason to challenge the validity of any contractual obligations which were created between the company and the deceased"
- "Assuming that the company was not a sham then the capacity of the company to make a contract with the deceased could not be impugned merely because the deceased was the agent of the company in its negotiation"
- "It is the logical consequence of the decision in *Salomon's* case that one person may **function in dual capacities**"
- In other words: **the company is a separate legal entity and its sole director/shareholder can also be an employee who entered into a contract with it.**

A corporation has power to acquire, hold and dispose of property: *Macaure v Northern Assurance Co Ltd (1925)*

Since *Salomon* the complete separation of company and its members has never been doubted (though the corporate veil, ie, the separateness between the company and its shareholders, can be lifted in some cases).

PIERCING THE VEIL OF INCORPORATION

Introduction

The 'corporate veil' is the '**separateness**' between the shareholders/directors and the company itself – it refers to the **limited liability** of shareholders for the debts of the company. 'Piercing the corporate veil' is when a creditor manages to get something from the shareholder.

- The veil is only 'pierced' in special situations, such as where there was **fraud, improper conduct, agency** etc.
- Several statutory provisions contain directions to pierce the veil of incorporation.
 - The principal exception in the Act itself arise when debts are incurred by the company when it is insolvent or solvency is impaired by incurring that debt → Its directors are exposed to personal liability for those debts where they knew or ought have known of the insolvency: s 588G
 - Where the company is a subsidiary of another company, that holding company may also be made liable in s588V-588X

Fraud or improper conduct

Shareholders using the corporation for the purpose of **fraud or an improper purpose** (Avoiding legal obligations) will **not be protected by the corporate veil and limited liability**.

Gilford Motor Co Ltd v Horne (1933): Avoid existing legal obligations/fraud

- **Facts:** Gilford was a car manufacture business and Horne worked for it. He had a **restraint of trade clause** in his employment contract, but he ignored it after he left Gilford and started a competitor business. He then set up a company in his wife's name and tried to rely on the corporate veil to protect himself personally.
- **Held:** the second company was ultimately held to be a **fraud** used by Horne to conduct his **business in violation of the restraint of trade clause**. An equitable injunction was granted against Horne.
 - Court granted an injunction against both Mr Horne and his new company on the basis that his new company was a "**mere cloak or sham**" allowing him to breach the covenants in his service agreement.

Jones v Lipman (1962): Avoid existing legal obligations/fraud

- **Facts:** Lipman was selling land to Jones. Before completion, Lipman changed his mind instead sold the land to a company owned by him for a significantly lower sum (so as to retain the land). Jones sought to enforce the contract.
- **Held:** "The defendant company is the creature of the first defendant, a device and a sham, a mask which he holds...in an attempt to avoid recognition by the eye of equity...an equitable remedy is rightly to be granted directly against the creature in such circumstances".