Introduction to Corporate Law

Types of Companies

	Proprietary (Pty Ltd)	Public (Ltd)
Shareholders s 45A(1); s 113	Minimum 1 shareholder Maximum 50 shareholders	Minimum 1 shareholder No maximum
Members s 114	Minimum 1 member	Minimum 1 member
Directors s 201A	Minimum 1 director	Minimum 3 directors (2 resident)
Finance s 45A(1); s 113	Cannot obtain funds from the public	Can obtain funds from public (w/ disclosure document)
Listing s 45A(1); s 113	Cannot be listed	Can be listed or unlisted
Type s 45A(1); s 113	Limited by shares Unlimited by shares	-

Company limited by shares	A company formed on the principle of having liability of its members limited to the amount if any unpaid on the shares respectively held by them
Company limited by guarantee	A company formed on the principle of having the liability of its meters limited to the respective amounts that the members undertake to contribute to the property of the company if it is wound up
Unlimited liability company	A company whose members have no limit placed on their liability
No liability company	**Section 112 - No liability companies** • Has a share capital and all its members must hold shares, but the members are not liable to pay any calls on their shares. • Only used for mining companies — highly speculative, high risk — must have a constitution

Corporate groups	• **Section 46:** a body corporate is a subsidiary of another body corporate if, and only if;
	  • The other body:
	  • Controls the **composition of the first body's board**; or
	  • **is in a position to … control the casting of more than one-half of the maximum number of votes that might be cast at a GM of the first body; or**
	  • **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

Corporate Personality & Limited Liability

Doctrine of Corporate Personality

- In particular situations, the courts and legislature pierce the corporate veil, ignoring the corporate entity and looking instead to those who control it or its affairs
- The business corporation usually has an entity status as distinct from that of its members
- Registration creates a separate legal entity, which facilitates limited liability

Limited Liability

- Corporate personality serves the function of marking out an asset pool against which creditors of the enterprise have prior claims
    - Entity status 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 and directors to the claims of the firm's creditors
    - Since the liability of shareholders to contribute to this asset pool is limited to the amount unpaid on shares held, the risk of business failure may well fall upon company's creditors
- Unfair to impose unlimited liability on shareholders where they are not directly responsible for the acts of the corporation
- Creditors are better risk bearers than shareholders, and can bargain for protection

Key arguments in favour of limited liability	
Encourages investment	• Limited liability encourages investment by those who have no interest in or capacity for management participation • Unlimited joint and several liability would significantly disincentivise investment by passive investors
Division between ownership and control	• Limited liability represents a rational response to the division between ownership and control
No need to monitor fellow shareholders	• Limited liability relieves shareholders of the need to monitor fellow shareholders capacity to contribute proportionately in the event of insolvency
Encourages liquidity of share capital	• Limited liability encourages free liquidity of share capital • This both reduces the cost of capital for the company, and creates an accountability mechanism — as poor performance will be reflected in stock price decline, which will stimulate acquisition of control by a party which believes it can achieve superior returns
Makes market pricing of shares effective	• Sharemarket price mechanism will only be effective if the price reflects the worth of the share itself, and not the shareholder's financial capacity to contribute to the company's deficiency • By impersonalising the share, it can trade at a single price • Unlimited liability regime would mean that the value of the shares is inherently attached to the shareholder
Encourages risk-taking	• Companies can safely invest in projects with prospects of significant returns, but also with significant risk exposure
Encourages portfolio diversification	• Shareholders have a greater inclination to diversify their portfolios under a limited liability model

- **Key criticisms include:**
  - Benefits to shareholders are matched by risks to creditors - informational asymmetries
  - Traditional justifications for limited liability are absent in closely held corporations and subsidiary companies
  - Tort claimants against a company may be more vulnerable than contract creditors, who can bargain for desired protections and a rate of return commensurate with the risk
  - Moral decisions often blurred by economic demands and the anonymity of group decision
  - Can encourage excessive risk-taking
    - Directors feel like they can hide behind corporate personality

Corporations Act (2001)	
s 124	A company has the legal capacity and powers of an individual… [as well as] all the powers of a body corporate, including the power to… issue/cancel shares; grant security interests in uncalled capital; do anything that it is authorised to do by any other law
s 125	**If the company has a constitution, it may contain an express restriction on, or a prohibition of, the company's exercise of its powers.** **If a company has a constitution, it may set out the company's objects.** **An act of the company is not invalid merely because it is contrary to an express prohibition in the constitution, or beyond the objects stated**
s 201A	Proprietary company must have at least 1 director who ordinarily resides in Australia Public companies must have at least 3 directors, 2 of whom ordinarily reside in Australia

Separate Personality of the Corporation

***Salomon v Salomon & Co Ltd* [1897]**	
Facts	• Salomon was a sole trader, and then in 1892 arranged for the incorporation of a company called "Aron Salomon and Company Limited" • Act required seven subscribers, and so Salomon gave 6 family members 1 share each • The company agreed to purchase the business for £39,000, and Salomon was issued with 20,000 fully paid £1 shares and debentures with a face value of £10,000 • Mr Salomon was the majority shareholder and the primary creditor (owed £10,000 under the debenture) when the company was wound up • On sale of the assets, the sum realised was less than the amount of the debenture held by Mr Salomon, and the unsecured creditors received nothing
Issue	Should Mr Salomon's secured debt of £10,000 take precedence over unsecured creditors who were owed approximately £11,000?

Outcome	• **House of Lords:**
	  • The condition of the statute had been satisfied — existence of 7 shareholders
	  • Statute is silent on the required extent or degree of interest
	  • **Motive behind becoming a shareholder is not a legitimate line of inquiry**
	  • When all the shareholders are perfectly cognisant of the conditions under which the company is formed, cannot contend that the company is being defrauded
	  • There is nothing in the Act requiring that the subscribers be independent or unconnected
	• **The company is at law a different person altogether from the subscribers to the memorandum —** even if the business is the same as it was prior to incorporation

- **A company exists as a separate legal entity, separate to its members and separate to its directors**
- **<u>The fact that a company, which is properly formed, is totally controlled by one person does not establish agency</u>**

***Lee v Lee's Air Farming Ltd* [1961]**	
Facts	• Lee formed a business, and held the whole of the issued capital except for one share held by his solicitor • By virtue of his powers as **governing director** and controlling shareholder, Lee enjoyed full and unrestricted control over the affairs of the company • Governing director — all managerial control • Mr Lee was employed by the company as its chief pilot and was killed • Lee's widow sued the company for compensation as the widow of a "worker", defined as a "person who works under a contract of service with an employer" • NZCA rejected the claim on the basis that Lee could not be both the company's governing director and its servant • His widow appealed to the Privy Council
Issue	Was Mr Lee a worker within the meaning of the Workers' Compensation Act?
Outcome	• **At the relevant time, Lee was piloting an aeroplane belonging to the company, carrying out the operation of top-dressing farm lands from the air** • He was paid wages, and these were recorded in the company's wages book • **The deceased, as one legal person, was willing to work for and to make a contract with the company, which was another legal entity** • The mere fact that someone is a director of a company is no impediment to his entering into a contract to serve the company • Contractual obligations were not invalidated by the circumstance that the deceased was the sole governing director in whom was vested the full government and control of the company • Capacity of the company to enter a contract with the deceased could not be impugned merely because the deceased was the agent of the company in its negotiation • **One person may function in dual capacities within a company** • **Company is separate even from its controllers**

Piercing the Veil of Incorporation

- The corporate veil exists once a company is registered and it separates the company from the people who formed it — **s 124**

Company		Members
Company is its own separate legal entity with its own assets, liabilities & contracts	**VEIL**	• Own shares but not a proprietary interest in the company's assets • May also be a creditor, debtor or director of the company

- There are some instances in which courts will identify the company with its members or managers
  - In *Salomon,* Lord Davey was prepared to identify the company with the totality of its shareholders when they acted as a group
  - A company's place of residence for tax purposes has been identified with that of its central management

- Legal personality and limited liability can permit the structuring of risk business in such a way as to quarantine liability
- The principal cases, wherein the veil of incorporation has been pierced, **tend to concern fraud or improper conduct, agency,** and the limited recognition accorded to the unity of the enterprise of a group of companies under common ownership
    - May be misleading to think of these as categories
    - 'They reveal no consistent principle beyond **a refusal by the legislature and the judiciary to apply the logic of the principle laid down in *Salomon* where it is too flagrantly opposed to justice, convenience, or [tax]'**
- Further, several statutory provisions contain direction to pierce the veil
    - Usually where debts are incurred by the company when it is insolvent, or its solvency is impaired by incurring that debt
        - Directors will be exposed to personal liability for those debts **where they knew or ought to have known of the insolvency — s 588G**
    - Where the company is a subsidiary, the holding company may be liable for the subsidiary's debts where it knew or ought to have known the state of its financial affairs — **s 588V-X**

I. Agency

- Because of ***Salomon***, Courts are very reticent to construe a relationship as one of agency

***Smith, Stone & Knight v Birmingham Corp* [1939]**	

Facts	• SSK, which operated a paper manufacturing business, bought out the partners of a paper distribution business, which it then had incorporated
	• The paper distribution business remained under the full control of SSK
	  • Directors were appointed by SSK
	  • All the profits went straight to SSK (without declaration of a dividend)
	  • All the shares were effectively owned by SSK
	• For all intents and purposes, the subsidiary was treated more as a division
	• The subsidiary's business was operated on land owned by SSK
	• The local council purchased the land to carry out public works
	• SSK applied for compensation for the cost of relocating the subsidiary's business
	• Compulsory acquisition laws provided that tenants without a long-term lease were not eligible compensation — they only had a temporary lease

Issue	Who was the proper party to sue for compensation — SSK or the subsidiary?
Outcome	• The degree of **control and dominance that the parent company had over the subsidiary established an agency relationship** such that the parent, SSK, was entitled to compensation for disturbance to the business operated by the subsidiary

- **Six questions from *Smith*:**
    1. Were the **profits** treated as the profits of the parent?
    2. Were the **persons conducting the business appointed** by the parent?
    3. Was the **parent the head and brain** of the trading venture?
    4. Did the parent **govern the adventure, decide what should be done and what capital should be embarked** on the venture?
    5. Did the parent make the **profits** by **its skill and direction?**
    6. Was the parent in **effectual and constant control?**
- **BUT** this has been highly criticised
    - **'Mere dominance and control by the parent company is, in and of itself, not enough to establish agency' — Australian position**
    - Better question might be — could the subsidiary survive on its own?

Re FG Films [1953]	
Facts	• FG films wanted *Monsoon* registered as a British film, and applied to be declared as the 'maker' of the Act (so as to access a subsidy) • The Board of Trade refused because it was made by the American 'Film Group Inc' • The American company had promised to finance and provide facilities to the UK company for making the film • 90 shares were held by an American director and 10 by a British one • No shares were held by the third director, who was British • The film was made in India
Outcome	• The film could not be considered British made, even though the company owing the rights was a UK company • The participation was so small as to be practically negligible • They acted merely as the nominee of and agent for the American company

II. Fraud or improper conduct

- The use of a company by its controllers in an attempt to avoid an **existing legal duty** that otherwise falls on the controller personally
  - WILL NOT CATCH OBLIGATIONS WHICH MAY ARISE IN THE FUTURE
- **Whole purpose of incorporation must be to evade existing legal obligations**

Gilford Motor Co Ltd v Horne [1933]	
Facts	• Plaintiff company manufactured, sold and serviced Gilford motor cars and parts • In 1928, Horne was appointed as its managing director, then fired 3 years later • His employment contract had a restrictive covenant, preventing him from trying to solicit the business's customers following termination • He set up a competing company after leaving, called *JM Horne & Co Ltd*
Issue	Had Horne established the company solely to avoid breaching his restrictive covenant?
Outcome	• Horne had an existing legal obligation • He incorporated for the sole purpose of avoiding the restrictive covenant • Company was a mere cloak or sham - a device for enabling Horne to continue to commit breaches of his services contract

Jones v Lipman [1962]	
Facts	• Lipman entered into a contract to sell his house to Mr and Mrs Jones • Lipman subsequently decided that he did not want to proceed with the sale • In an attempt to keep control of the house, he entered into a further contract to transfer the property to a new company created for this purpose • Lipman owned and controlled the company • He wrote to the Jones' solicitors advising that he had sold the property, recognising that it constituted a breach of contract, and offered to pay damages • Mr and Mrs jones sought specific performance of the contract, against both Lipman and the company

Jones v Lipman [1962]	
Outcome	• Lipman sought to rely on Salomon, arguing that the company was now owner of the property • The Jones' relied upon Gilford, and this was accepted by the Court • The Court described the company as ***'a device, a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity'***

Fair Work Ombudsman v Ramsey Food Processing [2011]	
Facts	• The Ramsey Group of companies was set up for the purposes of running an abattoir • Ramsey was the guiding mind of the group • Ramsey Food Processing operated the abattoir • Tempus Holding supplied staff to Ramsey Good under a purported labour-hire arrangement • In 2008, Tempus notified all staff that their employment was terminated and went into voluntary administration • Substantial money was owed to the employees • The Fair Work Ombudsman initiated proceedings against Ramsey Food for the outstanding employee entitlements — on the basis that Ramsey was the true employer

Outcome	• Court held that Ramsey was the true employer and liable to pay the outstanding employee entitlements
	• The finding was based on the fact that Tempus was completely reliant upon Ramsey
	  • No assets
	  • No management structure
	  • Did not operate as an independent business
	• Tempus was a corporate shell to protect Ramsey Food from liability from employees

Prest v Petrodel Resources Ltd [2013]	

Outcome	• Distinguished between the **concealment** principle and the **evasion** principle
	  • **Evasion principle** — the court may disregard the corporate veil if there is a **legal right against the person in control of it which exists independently of the company's involvemen**t, and a company is interposed so that the separate legal personality of the company will defeat the right or frustrate its enforcement
	  • Many cases will fall into both categories, but in some circumstances the difference between them may be critical
	• 'There is a limited principle of English law which applies **when a person is under an existing legal obligation which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control**. The court may then pierce the corporate veil for the purpose, and only for the purpose, of **depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality**… I consider that if it is not necessary to pierce the corporate veil, it is not appropriate to do so, because on that footing there is **no public policy imperative** which justifies that course.'

III. Corporate Groups

- Among large-scale business, the group of companies is the dominant organisational structure
- 'Ltd' indicates a public company
- **Corporate group** — 'a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control'
- Competing conceptions:
    - Group as a family of **subsidiary companies under a holding company** that has majority ownership or voting control of the subsidiaries; or
    - Group as an **economic entity of a parent and its controlled entities** under a broader and more generally expressed definition of corporate control

Reasons for corporate groups	
Outcome of M&A	• They can be the consequence of M&A — taxation and stamp duty law favour this mode of acquisition over the purchase of the assets of the acquired business
Facilitate efficiency	• They can facilitate organisational efficiency, by segregating different businesses or functions into separate companies
Limited liability	• They can maximise the benefits of limited liability by isolating the risk of business failure in a single entity
Partly-owned subsidiaries	• In the case of partly owned subsidiaries, to obtain control of another entity and access to its resources without the cost of acquiring all of its share capital

- **A subsidiary company is one in which another company (s 46):**
    - controls the composition of the board;
    - is in a position to cast, or control the casting of, more than half of the votes in a general meeting; or
    - holds more than half of the share capital.
- A company controls the composition of the board of a second company if it has the power to appoint or remove all or the majority of the directors of that company, even if only with the consent of another person
    - A company is deemed to have this power if:
        - No person can be appointed to the board of the second company **without the exercise by the first company of the power in favour** of that person (the power might derive from the company's constitution or an agreement between members); or
        - The person's **appointment as director of the second company follows necessarily from the person being a director of the first** (typically by provision in the constitution of the second company)
- Where a holding company owns the whole of the share capital of the subsidiary, it is called a wholly owned subsidiary
- A holding company that is not itself the subsidiary of another company is the ultimate holding company
- **The ultimate holding company and its subsidiaries are known as a group of companies**

Key issues with corporate groups	
Separate entity	• Question of whether company law should treat the group itself as the relevant legal entity, by ignoring the separate entity status of individual members of the group
Role of directors	• Should directors' duties extend to considering members of the group? • Should group controllers owe a duty of good faith towards outside minority shareholders in the group companies?
Liability for insolvency	• When the controlling company in the group is liable for the debts of an insolvent member
Separate assets	• Whether there should be a pooling of assets and liabilities in the liquidation of a group of companies

- Formally, the separate personality of each company is not diminished by its membership of the group
- Thus, directors of a company within a group are obliged to act by reference to their perception of its interest, and **not those of the group generally**
- Creditors of each company within the group are entitled to look only to the resources of that company for the discharge of their debts and obligations
- **Australian courts have tended to favour form over substance in this area**
    - **'The fundamental principle is that each company within a group is a separate and independent legal entity' — *Walker v Wimborne* (1976)**

***Industrial Equity v Blackburn* (1977)**	
Facts	• Industrial Equity declared a **special dividend** that amounted to **more than the company's current year profits** (company law has long held that a company may **only pay a dividend out of its profits** - s 254T) • The dividends could, however, be paid if the total profits for the corporate group to which Industrial Equity was the parent company were used • Several shareholders, including Blackburn, applied to the court to have the dividend declaration set aside as being invalid because it sought to make a payment otherwise than from Industrial Equity's profit
Issue	Whether, in ascertaining the amount of profits available for distribution by a holding company by way of dividend, it is correct to look at the profit of the holding company itself or to the group profit as disclosed by the consolidated accounts
Outcome	• **Mason J:** it can scarcely be contended that the consolidation provisions of the *Companies Act* operate to deny the separate legal personality of each company in the group. • **Thus, in the absence of contract creating some additional right, the creditors of company A, a subsidiary company within a group, can look only to that company for payment of their debts** • **A company that seeks to pay a dividend must draw only on its own profits and cannot use the profit of other related companies** because all companies are separate legal entities • **Corporate veil applies equally to corporate groups as it does to individuals** • **For directors, the duties are owed to the company — not the group** • Creditors have recourse only to the company with which they have contracted

- However, note greater UK willingness to pierce the veil

***DHN Distributors Ltd v Tower Hamlets London Borough Council* [1976]**	
Facts	• The ownership of the business, land and operation vehicles used in a single business operation were divided between three companies in a wholly owned corporate group • DHN was the holding company and ran the business • The land was owned by Subsidiary A, the operating vehicles were owned by Subsidiary B • Subsidiary A directors were DHN's • Subsidiary A had no business - its only asset was the land & DHN was licensee • Council compulsorily acquired the premises, and DHN had to close down • Compensation was already paid to Sub A • DHN could only get compensation too for 'disturbance of the business' if it had more than a license interest

Outcome	• **Held that DHN and the subsidiaries were part of a single economic entity**
	• Court of Appeal held that the separate group structure should not defeat the parent company's claim for compensation for disturbance of the business that would otherwise be available if they were conducted under a unitary rather than a group structure
	• When a parent company owns all the shares of the subsidiaries - **so much so that it can control every movement of the subsidiaries**, these subsidiaries are bound hand and foot to the parent company and must do what the parent company says
	• 'This group is **virtually the same as a partnership,** in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point… **The three companies should, for present purposes, be treated as one, and the parent company DHN should be treated as that one'**
	• Key factors in this case were that:
	  • the two subsidiaries were both wholly owned
	  • they had no separate business operations

***Qintex Australia Finance* (1990)**	
Facts	• Schroders was a stockbroking firm with various members of the Qintex corporate group being their clients • Schroders received a sell order relating to currency transactions from one of the members of the Qintex group and sold the currency, making roughly $11m profit • Schroders then received an order from the Qintex group to buy the same amount of currency that it had just sold, which it did, resulting in roughly a $1m loss because of changes in the value of the relevant currency
Issue	Which Qintex company should Schroders seek payment from to cover the debt?
Outcome	• Creditors **must look to the specific company within a group with whom they made a contract** for its enforcement, despite the practice of the companies acting as a group for business purposes • It may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained