<u>THE CORPORATE ENTITY</u> - INTRODUCTION

Objectives:
At the end of the lectures on this topic you should be able to explain (i) what a company is, (ii) the key sources of company law in New Zealand, and (iii) fundamental terms associated with company law.

Reading:
John Farrar and Susan Watson (eds) *Company and Securities Law in New Zealand* (2^{nd} ed, Thomson Reuters Ltd, Wellington, 2013) Chapters 1 and 2.
Peter Watts, Neil Campbell, Chris Hare *Company Law in New Zealand* (LexisNexis, Wellington, 2011) Chpt 1

<u>What is a company?</u>
Currently 600,000 companies in New Zealand, 44,000 companies created in last financial year. It's a popular choice for a business structure.

Long title of the Companies Act 1993;

> An Act to reform the law relating to companies, and, in particular,—
> (a) To reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks; and
> (b) To provide basic and adaptable requirements for the incorporation, organisation, and operation of companies; and
> (c) To define the relationships between companies and their directors, shareholders, and creditors; and
> (d) To encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power; and
> (e) To provide straightforward and fair procedures for realising and distributing the assets of insolvent companies.

s2 = A company is **a company that is registered** (or created) under **Pt II** of the **Companies Act 1993:**

A company, **once registered, is a legal entity in its own right:**
s 15 Separate legal personality: A company is a legal entity in its own right separate from its shareholders & continues in existence until it is removed from the NZ register
This means it can enter into contracts, own property, commit torts & crimes BUT differs in that doesn't physically exist. So it's **an entity that the law perceives as capable of incurring legal rights and obligations.** Incorporated societies are like this as well - Lawsoc is an incorporated society.

<u>Fundamental terms</u>
Can think about a company as a pool of funds (capital fund) that can be used for economic purposes - hopefully to make a profit. Where does that pool of funds come from? One source may be the shareholders. So it's the price a shareholder pays in return for membership rights known as shares. They don't own a share of the capital fund, they **contribute to the fund through buying shares but the ownership of the cash is passed to the company** and **instead they own a collection of rights such as voting rights**, voting appointing Directors, etc. Shareholders as a collective group are known as Shareholders in General Meeting and they decide who manages the capital fund, so the Board of Directors. Shareholders also have rights to wind the company up and to appoint a liquidator. You also have a right to get a return from your investment so you have a right to distributions (dividends).

Shareholders, share capital, shares: shareholders are **the individuals who contribute some or all of a company's capital** (*share capital*) **in return for specified rights** (*referred to as shares – eg dividends, returns, right to vote*).

Shareholders in general meeting: collective group of shareholders of a company who, by statute, are given power to make specific decisions (*eg appointing directors, liquidator – majority rule*)

Directors/Board of Directors: individuals appointed by simple majority of shareholders in general meeting – as a collective group (*board of directors*) have a statutory power to manage the business & affairs of a company

Constitution* – *optional: **document that supplements the rules governing the operation of companies** set out in the **CA 1993,** as is permitted or provided for by the **CA.** Companies Act provides the default rules for all companies in NZ. So **in many instances the default rule is the shareholders of the company can decide whether to accept, reject or modify rules in the Companies Act by making their own Constitution.** May deal with all/any of the following: rights, powers, duties & obligations of the company, individual shareholders, shareholders in general meeting, individual directors & the board of directors.

Debt/loan capital: **capital raised by companies through borrowings from third parties** (*contractual relationships*) – now governed by the same law as for ordinary individuals. Creditors are the individuals that the company owes an obligation to.

Closely/widely held companies: **refers to the number of shareholders a company has**: closely held – few shareholders; widely held –many shareholders. A company must have at least one shareholder but no upper limit as to how many shareholders they can have.

Small to medium enterprises (SMEs): closely held **companies – enterprises with fewer than 19 employees,** few specialist staff & personal ownership & management (owned & managed by the same persons). In the company law context, **personal ownership & management means the same individuals are the company's shareholders & directors. These enterprises make up 96% of all NZ businesses.** That means most companies in NZ are small to medium enterprises.

Public issuer: entities that raise funds from public in return for the allotment/conferral of securities. Rules governing public issuers are currently found in the **Securities Act 1978** & **Securities Markets Act 1978,** but this is likely to change in the near future, see the **Financial Markets Conduct Act 2013.** So over time these rules in this statute will replace the rules in the Securities Act.

Financial Markets Authority: The regulator of New Zealand's financial markets: see the Financial Markets Authority Act 2011.

Publicly listed company: one that is a public issuer & is also party to a listing agreement with NZX, as a result of which members of the public can buy & sell the issuer's securities on markets operated by NZX (*shares can be traded on the open market*).

Parent & subsidiary companies/groups of companies: groups arise when o**ne company (*parent*) holds all or at least a majority of shares of another company** (*subsidiary*). It is possible for one company to hold shares in a range of companies = group. If this occurs across countries, it is known as a multinational group of companies.

Key sources of company law in NZ

Companies Act 1993: hybrid of fundamental English law concepts & North American concepts.
Common law: **CA** not a code, not a complete restatement of company law in NZ – some areas still regulated by the common law *but* these are reducing all the time.

Related legislation: **Securities Act 1978, Securities Markets Act 1988, Financial Markets Authority Act 2011, Takeovers Act 1993, Financial Reporting Act 1993,** and HC Rules (more applicable to large, publicly listed companies).

e.g public issuers will have to deal with Securities law. A larger entity where a shareholder wants to transfer their shareholding to someone else thats about takeovers so thats the Takeover Act and also extra legal sources about contractual relationships such as the NZX listing rules. **Extra-legal sources:** NZX Listing Rules, Securities Commission 🖬 particularly relevant to judges when interpreting legislation or applying common law, thus relevant to the development of the law.

Companies and other Business Structures:

	Sole Trader	Partnership	Limited Partnership	Company
Governing legislation		Partnerships Act 1908	Limited Partnerships Act 2008	Companies Act 1993
Formation	No formal requirements	By agreement between the partners.	By the process specified in the LPA.	By the process specified in the CA 1993.
Participants	1	2 or more	2 or more (general partner(s) and special partner(s).	1
Separate legal personality	No	No	Yes	Yes
Ownership of capital	Sole proprietor	Partners	Limited partnership	Company
Contributors of capital	Sole proprietor	Partners	General and special partners	Shareholders
Constitution or agreement	Not required	Optional	Required	Optional
Management	Sole proprietor	Equal participation by partners.	General partners	Directors
Risk	Sole proprietor	Partners	Limited partnership and general partners	Company
Returns	Sole proprietor	Profit sharing between partners	Distributions approved by general partners,	Distributions to shareholders approved by directors.

With a company **because it's the contracting party, it's the liable party. It holds the liability not the individual.** So compared with a sole trader, individuals don't have the responsibility for the debts.

How do you register a company? It's all done online now.
The right to apply for registration

s 11 - any legal person can apply to register a company (that includes another company).

s 12 - statutory requirements of information.

There are forms that prompt someone to supply all the information required under s12.
Registration by the Registrar s 13
Certificate of incorporation is issued under s14 which says the process under the act has occurred and occurred validly.

SEPARATE CORPORATE PERSONALITY

Objectives:
At the end of the lectures on this topic you should be able to explain the historical development of the concepts of separate corporate personality and limited liability. Further, you should be able to explain and apply the legal rules relating to (i) the doctrine of separate corporate personality and limited liability, (ii) the consequences of incorporation, and (iii) exceptions to the doctrine of separate corporate personality and limited liability.

Reading:
John Farrar & Susan Watson (eds) Company and Securities Law in New Zealand (2nd ed, Thomson Reuters Ltd, Wellington, 2013) chapter 6.

Robin Cooke 'A Real Thing' in Andrew Borrowdale, David Rowe & Lynne Taylor (eds) Company Law Writings: A New Zealand Collection (Centre for Commercial and Corporate Law Inc, Christchurch, 2002) 21.

Peter Watts, Neil Campbell & Chris Hare Company Law in New Zealand (LexisNexis, Wellington, 2011) chapters 2 & 3.

Separate corporate personality s15

The principle of separate corporate personality is encapsulated in s 15 of the Companies Act 1993.

> **15 Separate legal personality**
> A company is a legal entity in its own right separate from its shareholders & continues in existence until it is removed from the NZ register.

Historical development: until **end 17th C:** incorporation/**creation of a legal person achieved by Royal Charter or Act of Parliament – both difficult & expensive** to achieve; 1720-1844: deed of settlement companies – large partnerships, although hardly a relationship of partnership, significant disadvantages for members & creditors; 1844 to present: **Joint Stock Companies Act 1844** (UK) – forerunner of **CA, s 15,** although rules differed in a number of ways, NB also introduced concept of default rule of limited liability for shareholders/members of a company (now restated in **CA, s 97**)

Historical development from the handout:
The steps that led to the widely available ability to incorporate a company with a separate legal personality from that of its shareholders can be divided into three periods:

- The period up to 1720.
- The period from 1720 through to 1844.
- The period from 1844 through to the present.

In the first period, incorporation, resulting in the creation of a legal person, was achieved by Royal Charter or Act of Parliament, both of which were difficult and expensive to achieve. Examples of early corporations are trade guilds and, in later times, companies like the East India Company or the Russia Company.

Nevertheless **attempts were made to devise a legal structure that could accommodate large numbers of individuals associating together for the purposes of economic gain.** These attempts **resulted in what is known as the joint stock company.** Use of the term "company" in this context **did not carry its modern meaning of a separate legal person. Instead, "company" carried its colloquial meaning: a collection of individuals.** By contract or deed, individuals contributed funds to a common pool to carry out a business venture. **Each individual retained ownership of his or her share of the contributed funds.** Contributors agreed to share the profits and losses of the venture. A practice developed where, by agreement, contributors could transfer their "share" of the fund and any resulting profits without the consent of the other contributors. "Share" in this context did not refer to the collection of rights, but to the contributors' ownership of a part of the common fund.

The early 18th century was a time of economic boom and then speculation. Shares in joint stock companies were often bought and sold at a price that did not reflect the actual value of the assets acquired with the underlying fund. In 1720 the boom turned to bust and many individuals found they were holding shares worth a fraction of the value which they had paid for them, leading to economic ruin for many. The English Parliament responded with the **Bubble Act of 1720 which prohibited the establishment of joint stock companies with freely transferable shares**.

However, the economic needs of the time necessitated the development of a form of business structure that allowed the aggregation of large amounts of capital. **Deeds of settlement companies were a more refined attempt at a structure to accommodate a business venture with a large number of investors.** Despite their name, these entities were in fact large partnerships. By deed, **"partners" would contribute to a common fund.** Specialist managers (the precursor of the modern director) were appointed to manage the fund. The interest of individual partners in the common fund was termed a "share". "Partners" were permitted to transfer their interest in the fund and although this practice contravened the Bubble Act it was generally ignored by regulators. In practice it was farcical to regard the relationship between members of these organisations as one of partnership. There were also significant disadvantages associated with deed of settlement companies for both partners and the creditors who dealt with them.

It is the **Joint Stock Companies Act 1844 (UK) that is the forerunner of s 15 of the Companies Act 1993,** although the rules governing companies and shareholders under this statute differ from more modern rules in a number of ways. **The liability of members was unlimited.** A minimum of **25 members was required.** Limits were also placed on the numbers of individuals able to carry on business in partnership. The Joint Stock Companies Act was the result of pressure to regulate large collections of individuals carrying on an association for the purpose of economic gain.

It was the desire to regulate large collections of individuals carrying on an association for economic gain that led to the birth of the modern company. Early company law was developed to regulate this type of entity and even today the Companies Act 1993 is drafted so that **its default rules suit widely held companies rather than the small to medium enterprises, SME's, that make up by far the majority of present day companies.**

The above commentary focuses on the English position but until the enactment of the Companies Act 1993, company law in NZ was a facsimile of English legislation: see the Joint Stock Companies Act 1860 and the Companies Acts of 1882, 1903, 1908, 1933 and 1955.

Limited liability s97

Consider for a moment the position for an investor who acquires a small number of shares in a widely held company. The management of the company is out of the investor's hands on a day to day basis. Because of the small number of shares owned by the investor, he or she is unable to control how shareholders vote on matters reserved to them by statute and/or the company's constitution. If the company fails, the investor is liable for its debts in accordance with the proportion of its shares that he or she owns. Would you consider this an attractive investment? - this is why we need/have limited liability.

The concept of a default rule of limited liability for the shareholders of a company was introduced by the Joint Stock Companies Act 1856 (UK). The concept is restated in **s 97 of the Companies Act 1993.**

Shareholders have **no personal liability to third parties** for obligations of the company by reason only of being a shareholder, unless the constitution so provides: **97(1)**

The liability of shareholders **to the company,** unless the constitution so provides, is limited to the matters set out in: **97(2)**

The liability of shareholders **to the company** in tort, contract, equity or any other actionable wrong (*ie some other kind of legal relationship*) is preserved: **97(3)**

97 Liability of shareholders

(1) **Except where the constitution of a company provides that the liability of the shareholders of the company is unlimited, a shareholder is not liable for an obligation of the company by reason only of being a shareholder**

(2) Except where the constitution of a company provides that the liability of the shareholders of the company is unlimited, the liability of a shareholder to the company is limited to

(a) Any amount unpaid on a share held by the shareholder

(b) Any liability expressly provided for in the constitution of the company
(c) Any liability under ss 131-137 of this Act that arises by reason of s 126(2) of this Act
(d) Any liability to repay a distribution received by the shareholder to the extent that the distribution is recoverable under s 56 of this Act (*made where company insolvent*)
(e) Any liability under s 100 of this Act

(3) **Nothing in this section affects the liability of a shareholder to a company under a contract, including a contract for the issue of shares, or for any tort, or breach of a fiduciary duty, or other actionable wrong committed by the shareholder.**

21 Name of company if liability of shareholders limited
The registered name of a company must end with the word "Limited" or the words "Tapui (Limited)" if the liability of the shareholders of the company is limited.

What answer does s 97 give to the following situations?

- X Ltd enters into a valid and enforceable contract to buy goods from A. A delivers the goods, but X Ltd refuses to pay for no good reason. Where should A direct her claim for payment? *She can only direct it to X Ltd, she can't direct it to the Shareholders because they have limited liability shown by having Ltd at the end of their name.*

- The **constitution of Y provides that the liability of its shareholders is unlimited.** Y enters into a valid and enforceable contract to buy goods from C. C delivers the goods, but Y refuses to pay for no good reason. Where should C direct his claim for payment? *C can seek payment from either Y's shareholders or the company under s 97(1) because the constitution provides for unlimited liability.*

- A liquidator has been appointed to Z Ltd. At the time of commencement of Z Ltd's liquidation, **D has not fully paid the issue price of the shares that he holds in Z Ltd.** Can the liquidator validly pursue D on behalf of Z Ltd for this unpaid sum? *So this is the company trying to make a claim against one of its own shareholders for not paying money it should have. They can make a claim against that shareholder - they are still liable to the company and the liquidator can make that claim on the company's behalf. s97(2) is looking at shareholders liability to the company - not outside people. If you receive a distribution when the company is insolvent then you may be asked to return it.*

- B, a shareholder of X Ltd, agrees to purchase goods from X Ltd pursuant to a valid and enforceable contract. X Ltd delivers the goods. B does not pay. Can X Ltd can enforce its contract against B? *Dealt with under s97(3). Limited liability has nothing to do with the other legal relationships a shareholder might have with the company outside of the shareholding relationship. B here not acting as a shareholder, acting as a contracting individual so nothing to stop X enforcing this contract against B.*

Justification for limited liability **(Easterbrook & Fischel):**
Limited liability:
- **Decreases the need for shareholders to monitor actions of management** & other shareholders
- Encourages diversification of investment by shareholders,
- **Promotes transfer of shares in companies**
- Promotes economic efficiency

This justification is reflected in **CA, Long Title, para (a):**
An Act to reform the law relating to companies, &, in particular –
(a) **To reaffirm the value of the company as a means of achieving economic & social benefits** through the aggregation of capital for productive purpose, **spreading of economic risk, & taking of business risks.**

Essentially – if a company fails, its shareholders may lose their investment (*rights as shareholders*) *but* will not have to meet any debts of the company to creditors. *Thus* the effect of limited liability is to

shift the risk of loss when a company becomes insolvent (*unable to meet its obligations*) **from shareholders to creditors (**those to whom the company owes obligations). **Onus on creditors to take steps to protect their own position** – e.g. take security over company's assets, require guarantees of debts from directors or shareholders. More of a focus now on recovery from directors rather than shareholders. So if the company is unable to meet it's obligations, it is individual creditors affected who must bear this loss.

IOD Website - good page for companies overview up to this point.
https://www.iod.org.nz/FirstBoardsFirstDirectors/FirstDirectors/Thelegalframework.aspx

Separate corporate personality & the courts

This includes judicial attitudes to separate corporate personality.

***Salomon v Salomon & Co Ltd* [1897]** (HL – *Lord Macnaghten*) (*The foundation case of company law*)
S carried on successful business as sole trader manufacturing boots, had many contracts with the Govt to supply the army. So his business was established and profitable. He employed a number of sons in the business, who wanted more of a role and a share in the business. So he incorporated a company, Salomon & Co Ltd, & transferred the business to the new company for £39,000 *(this was a generous, not excessively over-value but did reflect a fond belief in the business by Salomon. You think it's worth more because it's yours*). Obviously the company had no capital funds so how would it pay for the business transfer? In return, **S was issued with 20,000 shares, his wife with 1 share, & each of his 5 children with 1 share each** (legal requirements of the day obliged a company to have 7 shareholders) and also **Salomon would get £1000 pounds in cash.** S was appointed as a director as well as one of his sons. Plus S agreed to leave part of the purchase price owing in the business **so took a mortgage/debenture over the company's assets contractual relationship**. So as security for the advance of funds, the company gave S a mortgage/security (known as debentures) over it's assets.

A year after the company was transferred, there was a downturn in the industry, the Govt contracts were lost, & the company got into debt of £77,331. S & Co **became insolvent (couldn't pay its debts as they fell due),** a liquidator was appointed to determine and sell the company's assets & distribute returns to creditors. The set **order of priorities go like this = secured – preferential – unsecured – balance to shareholders.** The contest here was between S as a secured creditor and everyone else who had no security. If the debentures were valid and he sold those assets then there would have been nothing left to the other creditors who were owed £7700. **S had 2 legal relationships with the company – major shareholder & secured creditor (debenture).** Liquidator was not prepared to recognise the validity of S' debenture, which would have given him priority. In the **lower courts (first instance and COA)** they focused on the way in which shareholding & control was allocated in the company. They **viewed what S had done as some kind of scheme to take advantage of limited liability and also the separate personality in that he could enter that contract for security over the assets.** S retained the same control as he had when he was a sole trader and the company carried on the **same business as if S was a sole trader, thus they felt he had taken advantage of the ability to incorporate,** limit his liability & gain preference over other creditors. The court thought that the wife and children were there as dummies to make up the minimum shareholders, to make up the numbers, but it was still S's business. The lower courts categorised the company as either his agent or trustee, which **meant S could rely on debenture but was still responsible for the obligations of the company including it's debts and thus obliged to indemnify the other creditors.**

HL rejected lower courts' reasoning.
Lord Macnaughten : *"**the company in law is a different person altogether from subscribers (shareholders)** and thought it may be that after incorporation the business is precisely the same as it was before and the same persons are managers and the same hands receive the profits, **the company is not in law the agent or the shareholders or the trustee for them".***

The company in law a different person altogether from shareholders and company is not in law the agent for, or
trustee of, its shareholders. **Shareholders do not need to participate in running the business. Shareholders have no personal responsibility for the company's obligations.** No concern with the merits of the situation (*ie Salomon's conduct*) – **up to creditors to look out for their own interests & check company's** creditworthiness. It was a matter of statutory interpretation - they looked at what was required to incorporate a company, that was valid here, and all the rules followed from that. The courts said they didn't need to look behind the statute. So Mr S had no personal responsibility for the debts of the company. And **because the company was a separate legal entity nothing to stop the valid contractual relationship between Mr S and the company - so S could rely on his security.**

***Lee v Lee's Air Farming Ltd* [1961]** (PC from NZ)
Top dressing pilot Lee, incorporated LAF in 1950s. Legislation at the time required minimum 2 shareholders – Lee was issued 2,999 shares & became the sole director (*thus controlled the board of directors & shareholders in general meeting*), his accountant was issued 1 share. LAF employed L as a pilot → contractual relationship. **So Lee was the major shareholder and the governing director (you were allowed to have one director in these smaller companies), but he was also an employee.**

LAF took out **workers compensation insurance** policy payable to families who lost their loved ones/workers at work (*pre-ACC*). L was killed in a plane crash. His widow sought compensation *but* **the insurance company refused to consider L an employee, claiming employment required some element of control by the employer over the employee.** The CA agreed this element of control was lacking – L effectively gave orders in his capacity as director & received orders in his capacity as an employee. L had self control over the management of the company and because of that he was in the position of giving orders to himself. So that's incompatible with an employment relationship - you need employer control element over an employee and that wasn't here said COA. **But PC took a different view.** The **court looked at what capacity L was acting in while he was piloting the plane and the court concluded that during the flight he wasn't performing his role as governing director,** he would only be doing it if he was bound to do it by a contractual relationship with the company. So you need two contracting parties to make a contract. Contractual relationship between 2 valid parties – didn't matter L was acting in his capacity as director (*agent of the company who was the prinicpal*) when negotiating the contract, which means it's actually in fact the company giving the instructions too Lee not Lee himself. **When the fatal accident was suffered, L was performing the terms of his contract on the instructions of the company → required element of control present.**

So the Privy Council disagreed with the COA. *Lord Morris said at pp 333-335: The substantial question which arises is, as their Lordships think, whether the deceased was a "worker" within the meaning of the Workers' Compensation Act 1922 and its amendments. Was he a person who had entered into or worked under a contract of service with an employer?* ***The Court of Appeal thought that his special position as governing director precluded him from being a servant of the company****. On this view it is difficult to know what his status and position was when he was performing the arduous and skilful duties of piloting an aeroplane which belonged to the company and when he was carrying out the operation of top-dressing farm lands from the air. He was paid wages for so doing. The company kept a wages book in which these were recorded. The work that was being done was being done at the request of farmers whose contractual rights and obligations were with the company alone. It cannot be suggested that when engaged in the activities above referred to the deceased was discharging his duties as governing director. Their Lordships find it* ***impossible to resist the conclusion that the active aerial operations were performed because the deceased was in some contractual relationship with the company. That relationship came about because the deceased as one legal person was willing to work for and to make a contract with the company which was another legal entity.*** *A contractual relationship could only exist on the basis that there was consensus between two contracting parties. It was never suggested (nor in their Lordships' view could it reasonably have been suggested) that the company was a sham or a mere simulacrum. It is* ***well established that 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.*

In this connection reference may be made to a passage in the speech of ***Lord Halsbury in Salomon v Salomon and Co. [1897] A.C. 22****:*

> *"My Lords, the learned Judges appear to me not to have been absolutely certain in their own minds whether to treat the company as a real thing or not. If it was a real thing; if it had a legal existence, and if consequently the law attributed to it certain rights and liabilities in its constitution as a company, it appears to me to follow as a consequence that it is impossible to deny the validity of the transaction into which it has entered" (ibid., 33).*

A similar approach was evidenced in the speech of Lord Macnaghten when he said:

> ***". . . It has become the fashion to call companies of this class 'one man companies'. That is a taking nickname, but it does not help one much in the way of argument. If it is intended to convey the meaning that a company which is under the absolute control of one person is not a company legally incorporated, although the requirements of the Act of 1862 may have been complied with, it is inaccurate and misleading****: if it merely means that there is a predominant partner possessing an overwhelming influence and entitled practically to the whole of the profits,* ***there is nothing in that that I can see contrary to the true intention of the Act of 1862, or against public policy, or detrimental to the interests of creditors"*** *(ibid., 53).*

Nor in their Lordships' view were any contractual obligations invalidated by the circumstance that the deceased was sole governing director in whom was vested the full government and control of the company. Always ***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. The deceased might have made a firm contract to serve the company for a fixed period of years. If within such period he had retired from the office of governing director and other directors had been appointed his contract would not have been affected. The circumstance that in his capacity as a shareholder he could control the course of events would not in itself affect the validity of his contractual relationship with the company. When therefore it is said that* ***"one of his first acts was to appoint himself the only pilot of the company" it must be recognised that the appointment was made by the company and that it was none the less a valid appointment*** *because it was the deceased himself who acted as the agent of the company in arranging it. In their Lordships' view* ***it is a logical consequence of the decision in Salomon's case (supra) that one person may function in dual capacities.*** *There is no reason therefore to deny the possibility of a contractual relationship being created as between the deceased and the company. If this stage is reached then their Lordships see no reason why the range of possible contractual relationships should not include a contract for services and if the deceased as agent for the company could negotiate a contract for services as between the company and himself there is no reason why a contract of service could not also be negotiated. It is said that therein lies the difficulty because it is said that the deceased could not both be under the duty of giving orders and also be under the duty of obeying them. But this approach does not give effect to the circumstance that it would be the company and not the deceased that would be giving the orders. Control would remain with the company whoever might be the agent of the company to exercise it. The fact that so long as the deceased continued to be governing director, with amplitude of powers, it would be for him to act as the agent of the company to give the orders does not alter the fact that t****he company and the deceased were two separate and distinct legal persons.*** *If the deceased had a contract of service with the company then the company had a right of control. The manner of its exercise would not affect or diminish the right to its exercise. But the existence of a right to control cannot be denied if once the reality of the legal existence of the company is recognised.* ***Just as the company and the deceased were separate legal entities so as to permit of contractual relations being established between them, so also were they separate legal entities so as to enable the company to give an order to the deceased.***

REVISION

What is the result of an application of the doctrine of separate corporate personality in the following circumstances?

Q: A husband and wife lived in a property owned by a company in which the husband held all but one share. Is the home to be treated as the matrimonial home for the purposes of the PRA 1976?
A: The property is owned by the company so it's not the husband's property, so therefore not part of the matrimonial home. Husband has no beneficial ownership in the company's property.

Q: A controlling shareholder of a company affects fire insurance in his own name in respect of the property of the company. The insured property was destroyed by fire. Did the shareholder have an insurable interest in the property that was the subject of the insurance policy?
A: Insurance doesn't have to pay out to the shareholder because the property didn't belong to the shareholder. The property is the property of the company - the shareholder has no interest in the property so has no insurable interest in the property. Not a valid policy. Company's property is not the property of its shareholders: *Schubert; Macaura*

Consequences of incorporation/*separate corporate personality*

1. A company has perpetual succession: **s 15** – ***company continues to exist even if its shareholders or directors change, it will continue to exist until removed from register.***
2. **Company's property is not the property of its shareholders: *Schubert; Macaura***
3. Company can sue & be sued in its own name
4. **Company may contract with its controlling participants: *Salomon; Lee***
5. **Company's obligations are its own & not those of its shareholders**: **s 97(1); *Salomon***

Why incorporate a company?

Advantages:

- Separate corporate personality & limited liability – *default statutory rules*
- **Perpetual succession – *easier to transfer shareholding than sell a business***
- Ability to create different classes of shares – *can add to/alter statutory rights = flexibility*
- Ability to expand size (capital base) by issuing further shares – *NB fairly tightly regulated by Securities law*

Disadvantages:

- Cost of incorporation – *but not really significant ($162)*
- **Ongoing administration – *requirements:***
    - Keep accounting records: **s 194**
    - Retain company records: **s 189**
    - Prepare an annual report: **s 208(1)**
    - Appoint an auditor: **s 196**
    - File annual return with the Registrar of Companies: **s 214**
    - Prepare financial statements: **Financial Reporting Act 1993, s 10**
- Publicity – *online register of companies*
- **Duties imposed upon company directors** – *can no longer act in their own interests, common to small companies.*
- Position of minority shareholders – *NB can be addressed in constitution through exit mechanisms.*

Other considerations e.g. tax: as separate legal persons, **companies are responsible for tax – flat rate for all companies *but* government policy tax law shouldn't force people into one form of business structure over another,** so for tax purposes companies can be treated as partnerships.

<u>Exceptions</u> to doctrine of separate corporate personality & limited liability

As an initial point for consideration, can you foresee (or are you already aware of) potential problems arising from a strict application of the doctrines of separate corporate personality and limited liability? e.g. a company being used to avoid an individual's liability. Can someone rely on the separate corporate personality to avoid a drunk driver's company car being confiscated? District court judge said the company is a separate legal personality, it's not the offender's car so it couldn't be confiscated. But if the company wasn't incorporated and only took ownership of the vehicle after she'd been caught drunk driving then that would be fraud.

The first exception is parties entering into their own contractual arrangements. The second and third are common law and statutory exceptions to the concept of separate corporate personality and limited liability.

Lifting or piercing the corporate veil

Common law sees a company that is legally separate from the shareholders and calls this the corporate veil. The extent to whether it is disregarded it is said the veil is lifted or pierced. **If it's lifted or pierced then the company and shareholders are seen to be legally one and the same.** But use of the metaphor isn't helpful because doesn't tell us when the veil is lifted or what the result and consequences of that might be.

> The legislation is not intended to allow directors or shareholders to escape liability for illegal acts or use a company for a fraudulent purpose – the underlying idea **(Farrar)** is that the corporate form must be used for legitimate purposes.
>
> *Thus* the courts will, in some circumstances, "lift" or "pierce" "the corporate veil" so shareholders & the company are regarded in law as one entity, **& each becomes liable for the obligations of the other.** It is a means of **reducing the social cost of limited liability – a balance must be drawn between the benefits of limited liability & its costs, to prevent a socially excessive level of risk taken**. This occurs mostly in closely held companies where there is less separation between management & risk bearing, or in groups of companies where a subsidiary tries to reach the capital of its parent company. **Similarly, piercing is more likely in tort cases where the creditor is involuntary & cannot negotiate or compensation for the risk, rather than in contract**.
>
> **Easterbrook & Fischel describe piercing as rare, severe & unprincipled, happening only freakishly!**

The approach of the courts, common law exceptions

Is it possible for the courts to disregard separate corporate personality in the light of the wording of s 15 of the Companies Act 1993? See ***Official Assignee v 15 Insoll Avenue Ltd*** [2001] 2 NZLR 492. So is piercing still possible in NZ given s15? **Yes it is still possible to disregard separate personality and the ability of the courts to do this is longstanding and if it was to be removed by s15 then it ought to be expressly stated.**

In a series of cases, the facts of which all occurred prior to the coming into effect of the Companies Act 1993, the New Zealand Court of Appeal made a number of **obiter statements** on the issue of whether it is possible for the courts to disregard separate corporate personality. All technically obiter because in none of the cases did the court lift the veil.

***Official Assignee v 15 Insoll Avenue Ltd* [2001]** (NZ)
Notwithstanding the mandatory language of s 15, principle of disregarding separate corporate personality (*lifting or piercing the corporate veil*) remains part of NZ law.
But it should be exercised only in **exceptional circumstances** – generally only if the facts indicate a **sham** or **façade** when in reality there is no separate corporate entity.

***Re Securitibank Ltd (No 2)* [1978]** (CA – *Richmond P*)
Any suggested **departure from the doctrine** (*laid down in **Salomon***) **should be watched very carefully** – the veil should be lifted **only if its presence would result in substantial injustice.**

> "*It may be, as Lord Denning said in **Littlewoods Mail Order Stores Ltd v McGregor** that the doctrine laid down in Salomon v Salomon & Co Ltd [1897] AC 22 is to be watched very carefully. But that can*

> *only be so* ***if a strict application of the principle of corporate entity would lead to a result so unsatisfactory as to warrant some departure from the normal rule.*** *So far as this Court is concerned the starting point must be that the importance of the doctrine laid down in Salomon v Salomon & Co Ltd was re-emphasised by the Privy Council in Lee v Lee's Air Farming [1961] AC 12; [1960] 3 All ER 420. For myself, and with all respect, I would rather approach the question the other way round, that is to say* ***on the basis that any suggested departure from the doctrine laid down in Salomon v Salomon & Co Ltd should be watched very carefully".***

***Savill v Chase Holdings (Wellington) Ltd* [1989]** (CA – *McMullin J*)
Appropriate to pierce the corporate veil **only where special circumstances exist indicating that it is a mere façade concealing the true facts.**

> But this Court in ***Re Securitibank Ltd*** (No 2) [1978] 2 NZLR 136 cautioned against too ready a tendency to depart from traditional notions of company law. To the same effect is the speech of Lord Keith in ***Woolfson v Strathclyde Regional Council*** 1978 SC (HL) 90 at p 96. He said:
>
> *"I have some doubts whether in this respect the Court of Appeal properly applied the principle that it is appropriate to pierce the corporate veil only where special circumstances exist indicating it is a mere façade concealing the true facts."*

***A-G v Equiticorp Industries Group Ltd (in stat man)* [1996]** (CA – *McKay J*)
It is not a principle – it describes the process, if the apparent transactions are a sham, the Court must look behind them to ascertain the true position (*ie the real nature of a transaction & the reality of the relationship created*).

> ***"The phrase 'to lift the corporate veil' is a description of the process by which in certain situations the Courts can look behind the corporate façade and identify the real nature of a transaction and the reality of the relationship created.*** *It is not a principle. It describes the process, but provides no guidance as to when it can be used. If the apparent transactions are a* ***sham****, the Court must look behind them to ascertain the true position."*

Fraud, façade, sham:

So the courts might disregard the veil where the company is used as a facade or sham to conceal the true facts. **That is where someone is using the company to avoid a legal obligation.**

***Chen v Butterfield* (1996)** (*Tipping J*)
Definition of a sham: A transaction **deliberately drawn so as to give the appearance of creating legal consequences different from those which the parties intended.** Necessary that the parties have in mind the legal consequence X *but* deliberately, for whatever reason, draw their transaction so as to appear to create the legal consequence Y**.** Must show dishonesty or some kind of sharp practice

> *"A document will be a sham when it is deliberately drawn so as to give the appearance of creating legal consequences different from those which the parties intend...But for the document to be a sham it is necessary that the parties have in mind legal consequence A but deliberately, for whatever reason, draw their document so as to appear to create legal consequence B."*

NZ examples:
***Official Assignee v 15 Insoll Avenue Ltd* [2001]**
(Bankrupt = **recognition that the individual is insolvent - it's a declaration by the HC,** so it has legal consequences. One of which is being declared bankrupt means **your excess property passes by operation of law to a public official of NZ known as the Official Assignee. Whose task is then to distribute the property to the person's creditors**. Mr Russell in this case was trying to use the corporate veil to avoid this process). Bankrupt accountant **Mr Russell incorporated a company called 15 Insoll Avenue Ltd**. He played no formal role in the company, but appointed his girlfriend & brother as directors, **the shareholders were**

initially fictitious then the shares later transferred to his children without their knowledge (*company effectively used as a puppet*). **He controlled the company even though he wasn't officially involved in the company. So** the company's constitutional documents contained forged signatures. The company's original directors and shareholders were fictitious persons. Subsequent directors (Russell's brother and girlfriend) were Russell's puppets who either signed documents at his request or he forged their signatures. **Note that Russell himself could not be a director because he was bankrupt.** Shares in the company were later transferred to R's children, but it did not appear that they were aware of this (one gave evidence to this effect). Although Russell was neither a director nor shareholder of the company, he still controlled its affairs.

The company property (*15 Insoll Ave*) was bought partly with a bank loan & partly with Mr R's money. So Mr R contributed some funds to the company and also managed to persuade a bank to lend more money to the company. So **some of the property was purchased with funds that should have gone to the OA and then creditors.** As a bankrupt, Russell's property by law passed to Official Assignee for distribution to his creditors. During the period of R's bankruptcy, the company acquired a property at 15 Insoll Avenue. Part of the purchase price was funded by a mortgage from a bank. The rest of the proceeds came from Russell – but as a bankrupt these were monies that should have been available for distribution to his creditors. OA takes legal proceedings against the company in order to get a portion of the property value in order to distribute to creditors. One of the arguments was that this could be achieved by lifting the veil and seeing R as the effective controller of the company and that R and the company were one and the same.

The Official Assignee successfully sought an order that the property was R's – the company was a façade concealing the true facts, the corporate veil was pierced & the separate corporate personality of the company disregarded, thus R's property was available for distribution to his creditors.

Paterson J said at paras [38], [40]:

> *[The company] is,* ***in effect, a mask under which Mr Russell holds the Insoll Avenue property.*** *It was* ***created by fraudulent means*** *to ensure that property which Mr Russell proposed to acquire, could be kept away from his creditors.* ***An inability to lift the corporate veil in this case would lead to substantial injustice.*** *Thus, whether approached on the Lord Keith of Kinkel statement of principle or on the qualification expressed by Tipping J, I am of the view that this is* ***an appropriate case to lift the corporate veil. There are special circumstances which indicate that [the company] is a mere façade concealing the true facts.***
>
> ***The result of determining that the company structure is a sham and a mere façade enables the corporate veil to be lifted. That, in effect, means that the property at Insoll Avenue is the property of Mr Russell.***

So there's the fraud/sham exception to corporate personality so it's an example here that that company was also subject to R's legal obligation that his property goes to the OA.

Paterson said more in the judgment though - he used the law on trusts to effectively come to the same point. **Constructive trusts can be used to achieve the same result.** So **you could say that because of the fraud/sham the beneficial ownership of the property always was with Mr R and a constructive trust could be imposed to recognise that so a the company therefore held the property on trust for Mr R**. And once you establish Mr R owns it beneficially then the law and process of bankruptcy can apply. So there is a company law resolution here but Paterson J also indicating you can use trusts to cover the same result.

***Jones v Lipman* [1962]** (UK)
Lipman entered into a contract for the sale of land to Mr and Mrs Jones. He then decided that he did not wish to go ahead with the sale. **To deprive J of the right for specific performance, Lipman then incorporated a company, Alamed Ltd, and transferred the land to the company.** Lipman had complete control of the company. He was the **majority shareholder and the company's director**. The idea is that because L is no longer the owner of the land they can't do specific performance, they might have a claim for damages but the property is protected. Jones sued both Lipman and Alamed Ltd for specific performance. Russell J grants orders against both L & the company on the basis the **company was a device/mask held by L to avoid recognition of the situation in equity**. The Court **imputed his knowledge of the situation** (*ie J's equitable*

interest) **& obligations on the company.** So **both L and the company are bound by L's obligation with Jones.** So the individual's obligation is passed on to the company that he controls.

> *Lipman* ***admitted that the transfer to the company was solely to defeat the plaintiffs' right to specific performance*** *and to leave them to their claim in damages against him.*
>
> *Russell J made an order of specific performance against both Lipman and Alamed Ltd. He commented at p 836 that Alamed Ltd was* ***Lipman's creature was "a device and a sham, a mask that he [Lipman] holds before his face in order to avoid recognition in the eye of equity."***

Surely it would have been **easier to argue fraud is an exception to indefeasibility here** (land law) because **Alamed not a bona fide purchaser for value (had knowledge)**. But it wasn't pleaded here. So commentators argue do we even need these company law exceptions to separate corporate personality?

***Gilford Motor Co v Horne* [1933]** (UKCA) – *classic example*
GMC employed H as its managing director (*most senior employee*). His employment contract contained a valid Restraint of Trade clause preventing him from soliciting customers after he finished employment for a five year period. He left & began to solicit customers in a business in his own name. Realising he was breaching the clause, he incorporated J M Horne Ltd. **H had no formal role in the new company, his wife & a business associate were appointed directors & shareholders,** *but* **the company was effectively under his control & they followed his instructions to solicit GMC customers.** The evidence before the court established that JM Horne and Co Ltd was the 'channel' through which Mr Horne carried on business.

GMC successfully sought an injunction against GMC & also against H himself to prevent them breaching the ROT clause. The Court was satisfied **the company was formed as a device to mask the effective carrying on of the business by H** – under a cloak or sham, H was able to engage in the business he was contractually prohibited from carrying out.

> *Lord Hanworth MR said at p 956:*
>
> *I am quite* ***satisfied that this company was formed as a device, a stratagem, in order to mask the effective carrying of a business of Mr E B Horne****. The purpose of it was to try to enable him, under what is a cloak or a sham, to engage in business which, on consideration of the agreement which had been sent to him just about seven days before the company was incorporated, was a business in respect of which had had a fear that the plaintiffs might intervene and object…*

So the court effectively granted an injunction against Horne and against the Horne company. **There was piercing of the veil between H and Horne Co Ltd, the company was the facade behind which H was acting in an attempt to evade his contractual obligations.** So another example of fraud justifying the piercing of the veil.

Criticism from Commentators
A series of high level commentators **(Lord Cooke, Fords authors, Campbell)** believe piercing the corporate veil in these situations is completely unnecessary – other principles would give the same result in a more coherent & nuanced form, eg: ***Gilford Motor Co:*** GMC could have enforced its contractual obligation against H & **used the tort of unlawful interference with contractual relations against the company**, and wouldn't have mattered if they'd used another person to enter the contracts rather than a company. Unlawful interference with contractual obligations - helping someone to break their legal obligations. Also see above for the use of fraud as an exception to indefeasibility in Lipman. And constructive trusts in OA v Insoll Ave.
Insoll Avenue: the Judge even referred to **Lord Cooke's** argument – accepted the Court could have employed remedial constructive trust principles as an alternative means to come to the same result. These principles are more coherent & nuanced because the question always remains after such cases as to whether the corporate veil was pierced for *all* purposes, or whether it was pierced just to, for example, enforce GMC's ROT clause. Nevertheless it is part of the law & cannot be disregarded.

An example where veil wasn't lifted:
***Chen v Butterfield* (1996)**
Clydebank Ltd offered the lease of premises to the Bs. The **Bs didn't want to incur liability under the lease themselves so incorporated a company, Furniture Wholesalers Ltd, Bs were the directors & shareholders** – but it was a shell company; **no assets, sole purpose to enter into lease with Clydebank.** The **Bs were upfront about wanting to limit their liability, told Clydebank they were not prepared to guarantee the company's obligations.** Clydebank transferred property to C. Furniture Wholesalers defaulted under the lease, C sought to enforce the lease against the company & the Bs. But here **the situation DID NOT warrant the piercing of the veil** – Bs were upfront when the company was created, no sham or fraud. Onus on C to investigate & understand the company's financial position with respect to its obligations under the lease – authors of their own misfortune. The clear effect of limited liability is to put the onus on creditors to protect themselves and their interests, C knew all the facts and still entered contract. To lift the veil in this situation would erode commercial certainty

Recent developments
In 2013 the **UK Supreme Court** had occasion to consider the nature and ambit of the doctrine of piercing the corporate veil on two occasions.

VTB Capital plc v Nutritek International Corp [2013] 2 AC 337 (SC) is the first of these decisions.
VTB advanced a considerable sum ($US225 million) to Russian companies ultimately owned and controlled by Mr Malofeev, a Russian businessman. The Russian companies defaulted on repaying the advance very soon after it was made. Although VTB had taken security for its advance, it alleged that this was only worth $32-$40 million. VTB alleged it had entered into the arrangement on the basis of fraudulent statements made by Mr Malofeev and was pursuing a claim in tort against him (tort of deceit). VTB applied to amend its statement of claim to add an alternative claim for damages for breach of contract based upon a piercing the corporate veil argument. **If VTB's application was granted, it would argue that Mr Malofeev was liable as if he were party to the contract between VTB and the companies to which VTB had advanced funds.**

It comes to court on two interlocutory matters - one is that the English courts aren't the proper jurisdiction to hear this claim, given that the property and parties are all out of the UK. Agreed that it ought to go to the Russian courts, so matter never comes to trial. The second interlocutory matter was the attempt by the Russian bank to amend it's statement of claim and bring in a second argument - that the corporate veil between Malofeev and the companies should be pierced and that Mr M is liable for the companies he controls and their contracts with the Russian bank.

Lord Neuberger said at paras [132] and [140]: ***(NB* remember this is obiter because they decided on the facts of the case that it shouldn't be heard in this jurisdiction at all)**. He was faced with a three pronged argument that the doctrine of piercing the veil wasn't part of English law.

1) it's inconsistent with the principle of separate corporate personality and Salomon,
2) it's not even a principle, it's obscure and imprecise as a doctrine,
3) it's unnecessary to achieve justice, because where it has been applied the same result could have been achieved with a less controversial route. Neuberger accepted there was some force to this argument but in the end not convinced that all of the cases on lifting the veil could be explained by using another route.

He **affirms the fraud and shame exception and he effectively approves the comment made in the first instance case that to pierce the veil you've got to show control of the company by a wrongdoer and misuse of the company as a device to conceal that wrongdoing.** When he looks at the facts particularly here - he decides **this isn't the right circumstance to lift the corporate veil.** He thinks to do so here, would be an extension of where it's been done before. Mr M wasn't intended to be a party so the parties here are quite clear, he didn't conduct himself afterwards as if he was a party, and nothing to suggest to a reasonable outside observer that the situation was any other than what was intended and how it was represented. So to lift the veil here would be to interfere with the sanctity of contract law.