

Company law in malaysia – separate legal entity essay sample

[Business](#), [Company](#)



In a modern capitalist market economy, companies are a familiar part of everyday life. Companies own supermarkets, supply water, gas, electricity and petroleum products we are depending on. They publish the newspapers and provide our Internet services. We deal with companies so often as purchasers and users of their products and services that the image 'company' brings to mind is usually of an organisation concerned with marketing and collecting payment for products which the company has made (or bought in) or services it has provided. It is necessary to go behind this image to get to the company which is the subject of company law. As we all know in Malaysia there are different types of business entities. Local or foreign investors are coming to Malaysia to start a business.

Company has been defined as any formal business entity for profit which may be a corporation, a partnership, association or individual proprietorship. Often people think the term "company" means the business is incorporated, but that is not true. In fact, a corporation usually must use some term in its name such as "corporation," "incorporated," "corp." or "inc." to show it is a corporation. In Malaysia, a "company" is a business organisation that is registered (or "incorporated") under the Companies Act, 1965 or its predecessor legislation, Section 14(1) two or more persons, if they agree to become associated for any lawful purpose may incorporate a company. In reality, a company or a corporate person is an association of persons who have agreed to undertake their lawful undertakings through a company.

In order to incorporate a company, there are two stages that we have to go through, which are, pre-incorporation and post incorporation. In the pre

incorporation stage, the promoter is responsible to bring the company into the legal existence and ensure its successful running, and in order to accomplish his obligation he may enter into some contract on behalf of prospective company. Promoters are the persons involved in formation of a company. They will undertake the initiative to prepare necessary documents and do other significant works in order to register the company. Sometimes they become the first directors of the company once the company has been registered or they might find new directors.

While in the post incorporation stage, we have to ensure that all the things that have been stated in memorandum and article of association will be exercised. A company is also required to maintain the statutory books such as, Register of Members as has been provided in Section 158, Register of Substantial Shareholders as in Section 69L, Books of Accounts Section 167 etc. The responsibilities will increase once the company is incorporated. A company is an artificial person, which is capable of owning property. Who owns the company and benefits from the wealth which the company has, and who controls what the company does with its assets? Therefore, we will discuss more regarding the duties of the promoters and the effects of incorporations in Malaysia.

Promoters

Before a company can be formed, there must be some persons who have an intention to form a company and who take the necessary steps to carry that intention into operation. Such persons are called ' promoters'. According to Cockburn CJ in *Twycross v Grant* (1877), a promoter is a " person who

undertakes to form a company with reference to a given object and set it going and takes the necessary steps to accomplish the purpose". While in *Tengku Abdullah v Mohd Latiff bin Shah Mohd*, [1996] 2 MLJ 265 Gopal Sri Ram JCA said, " A promoter is one who starts off a venture-any venture-not solely for himself, but for others, but of whom, he may be one." The promoter lays the foundations for a Company in terms of negotiations, registration of the Company, obtaining directors and shareholders and preparing all the paperwork. However, because the promoter is such an important person in the formation of the company, the law places several responsibilities on him. These are known as fiduciary duties.

The promoters have fiduciary relationship with the company meaning that the promoters have a very close relationship with company and they acted as trustee of the company. The fiduciary obligations arise automatically once a person identified as a promoter. Therefore, promoters have fiduciary duties towards company which is not to make any secret profit without company's consent and to give full disclosure to the company any interest promoters have in any transaction to be entered into by the company. The promoters must make full disclosure of the profit made to the independent board of directors. If the promoters or some of the promoters are in the board of the directors, the board would not be considered as an independent board of the directors. If that's the case, the disclosure of interest of promoters should be made to the members of the company.

Cotton LJ in *Re Cape Breton Co* (1885) said that his duty as a promoter may arise even at the time he purchases a property with the property with the

intention of selling it to the company he is going to incorporate. Therefore, his role as the company's promoter does not end immediately once the company is incorporated, as in *Erlanger v New Sombrero Phosphate Co* (1878). In this case a syndicate purchased a lease of an island in the West Indies. The island contained deposits of phosphate of lime. Mr. Erlanger was the chief in the syndicate. The syndicate purchased the lease of island for £55, 000. Subsequently a company was formed by the syndicate and it sold the island to the new company for £110, 000 through a nominee. As a result the syndicate earned £55, 000 secret profit. The articles of the company empowered the directors to adopt the purchase of the lease, which was ultimately done. A prospectus was issued by the company giving a very favourable account of the scheme and many people bought shares.

The real circumstances of the purchase were not disclosed to the shareholders despite being questioned by the shareholders. Later an investigation committee was formed to investigate the incidence and it recommended the removal of the original directors and appointment of a new board of directors. The new board of directors was appointed and it rescinded the purchase contract and claimed for repayment of the money and shares which had passed to the syndicate. The House of Lords held that the purchase contract could be rescinded. He may continue to be a promoter even after the company has been incorporated, for the purpose of procuring capital for the company. A promoter can be compelled by the company to hand over any secret profit which he has made without full disclosure to the

company. The company can also sue for the rescission of the contract of sale by the promoter where the promoter has not disclosed his interest therein.

In the case where the secret profit is recoverable, the company decides not to rescind the contract as in *Gluckstein v. Barnes*. A company was able to recover the sum of £20, 000 made as secret profit which was not fully disclosed by the promoters. In this case a syndicate consisting of four persons bought a property known as 'Olympia' for £140, 000 from a liquidator. Then it sold the property to a company which it promoted for £180, 000 and made £40, 000 profit. The syndicate made another £20, 000 profit by buying securities on the property at a discount. A prospectus was issued by the company to the public to raise capital. In this prospectus the promoters disclosed £40, 000 profit but not the other £20, 000 profit.

The company went into liquidation within four years of its incorporation. The liquidator sued the syndicate to recover £20, 000 undisclosed profit. House of Lords held that the disclosure of secret profit was not full and allowed the liquidator to recover £20, 000 undisclosed profit from the syndicate. A promoter is subject to the following liabilities under the various provisions of the companies act. The liability of promoters is stated in Section 130 of Companies Act 1965. This Section provides that if a person is convicted of any offence in connection with the promotion, formation or management of a corporation, he shall be disqualified automatically from being a director or promoter for five years from the date of conviction or from the date of release from jail if he was imprisoned. However, the person can be appointed for such a position if he has obtained the leave of court. If a person is

convicted on allegations of an offence in connection with the promotion of a company, he might be disqualified by the court to become a director in the company.

Effect of incorporation

According to Companies Act 1965, Section 16(5) - On and from the date of incorporation specified in the certificate of incorporation but subject to this Act, the subscribers to the memorandum together with such other persons as may from time become members of the company shall be a body corporate by the name contained in the memorandum capable forthwith of exercising all the functions of an incorporated company and of suing and being sued and having perpetual succession and a common seal with power to hold land but with such liability on the part of the members contribute to the assets of the company in the event of its being wound up as is provided by this Act.

The principle of separate legal entity which is, after the incorporation of a company, it is regarded as an artificial person or juridical person, who has the rights and responsibilities similar to a living person, has been widely accepted and applied in the world of business, trade and industry. Once it is incorporated by complying with the prescribed procedure, it comes into being and is a separate legal entity from its members and officers. This principle differ a company from a partnership. A company as a separate person has members, who are effectively its owners, and it has directors, who control what it does and manage its business. But only the company as a separate person is responsible for the debts incurred in carrying on its

business. It will be qualified to sue or being sued by others for any wrongs committed against it. The principle that company is a legal entity separate from its members once it is incorporated was asserted in the case of *Salomon v Salomon & Co Ltd (1897)*.

The facts in this case disclosed that a company had been incorporated by Mr. Salomon in which he and members of his family were the only shareholders. The case came into limelight when the company's business turned out to be a failure. The value of the assets was insufficient to pay out both Mr. Salomon and the company's other creditors. Consequently, the creditors raised an issue whereby they argued that Mr. Salomon should not have received the payment from the company because the degree of control he exercised over the company. It was held by the House of Lords that despite Mr. Salomon having the control over the company, it was neither his agent nor trustee. This is because a company was treated as operating the business in its own right, and as being separate from its controller, for example like in this case of Mr. Salomon. Therefore, the charge given by the company to Mr. Salomon was valid and he was entitled to be paid his debt even though other creditors of the company would not be paid because the company had insufficient assets to pay all its creditors. The decision confirms that a company upon its incorporation is a separate legal entity from its members.

It is immaterial that the company bought over the business from its subscribers, and operated it as before; that third parties dealt with the same personnel; and that the same persons received the profits generated by the

business, previously as the partners and now as members of the company running that the business. As the debts were incurred by the company, the creditors can look only to the company, and not its members for repayment. Since the company and its members are separate legal entity, the liability of the members only limited to the amount of whatever they still owe the company. In the case of Salomon, Lord Macnaghten also commented that “there is nothing in the Act requiring the subscribers to the memorandum should be independent or unconnected, or that they or any of them should take substantial interest in the undertaking, or that they must have a mind and will of their own.” Therefore the fact that all the shares held for the benefit of one person will not affect the status of the company as a separate legal entity. It does not cause the company and the sole beneficial owner of the shares to be one legal person.

The principle was strengthened by the Privy Council in the case of Lee v Lee’s Air Farming Ltd (1961). This case was about the veil of incorporation and separate legal personality. Mr Lee is the owner and sole working director of a company engaged in the business of aerial crop spraying. Mr Lee held 2999 of 3000 shares was the sole director and employed as the chief pilot. He also took insurance for his employees. While he was performing his duties as a pilot, he was killed in an accident. His widow, the plaintiff, attempted to collect what was rightfully due to a widow of a man killed on the job. The actual defendant was an insurance company. The company was insured (as required) for worker compensation. The Lee’s Air Farming case confirmed the Salomon principle. Lee’s Air Farming Ltd. was not a mere sham. It was a

legitimate corporation, established for legitimate purposes, and had carried on a legitimate business. His employment by the corporation was well-documented through government records of tax deductions, workmen's compensation contributions, etc., and was not something his widow had attempted to piece together after the fact of his death.

There was no reason in law why a person could not perform corporate functions and employee functions within the same corporation. Mrs. Lee won the case and the compensation was paid. In another case, *Macaura v. Northern Assurance Co. Ltd.* [1925], Mr Macaura, had formed an estate company. Then he sold his owned timber estate for £42, 000 to the estate company, whereby the purchase money was paid by the company in the form of issuance of 42, 000 fully paid shares of £1 each. Macaura had affected an insurance policy on the timber in his own name, and not in the company's name. On 23 February 1922, most of the timber was destroyed by fire. Thus, Macaura claimed under his insurance policies. However, it was ruled by the court that Macaura had no insurable interest. The insurance policy effected by him could only be on the basis of a creditor or a shareholder of the company, which neither two has an insurable interest in the assets of the company based on the principle that a company is an independent entity. As was mentioned earlier, once a company is incorporated it will be a separate legal entity, which would qualify it to sue and being sued for any wrongs committed against it. The members are not permitted to take legal action on behalf of the company against the wrong doer.

If a wrong has been committed against the company, the member cannot take action on behalf of the company as in the case of *Foss v Harbottle* (1843). Certain burghers in Manchester purchased park land to dedicate to the then heiress of the throne Princess Victoria. The park opened to great acclamation but difficulties soon followed. It was alleged by some of the company's members that some directors had misapplied company's property. The case was heard by Wigwram VC. He held that the action could not proceed as the individual shareholders were not considered as proper plaintiff. He held that a wrong was committed against the company, and only the company could take the legal action. The members did not have legal standing to sue the wrongdoers because the members and the company were separate legal entities. In the case of *Newborne v Sensolid (GB) Ltd* (1954) 1 QB 45 a consignment of tinned ham was sold to Sensolid under a contract headed "Leopold Newborne (London) Ltd" and ending "Yours faithfully", Leopold Newborne (London) Ltd" and signed by Leopold Newborne.

Sensolid refused to take delivery of the ham. It was held that neither the then unincorporated company nor Mr Newborne personally could sue on the contract. Lord Goddard held that this contract purports to be a contract by the company; it does not purport to be a contract by Mr Newborne. He does not purport to be selling his goods but to be selling the company's goods. The only person to have any contract here was the company, and Mr Newborne's signature merely confirmed the company's signature...In my opinion, unfortunate though it may be, as the company was not in existence

when the contract was signed there never was a contract, and Mr Newborne cannot come forward and say: " Well, it was my contract." Upon the incorporation of the company the persons whose names appear in the company's register of members from time to time shall be the members of the company (Section 16(6)) and together they shall be a body corporate. As in Section 16(5), the body corporate shall enjoy a separate legal entity with an existence that does not depend on the identity of its members. Members come and go but the company will remain exist. In the case of Abdul Aziz Bin Atan & 87 ORS vs Ladang Rengo Malay Estate SDN BHD (1985) 2 MLJ 165, where all the shareholders of the company sold and transferred their entire share holdings to a certain buyer. Therefore, the court had to determine whether a change of employer took place.

The court held that an incorporated company is a legal person separate and distinct from its shareholders. The company, from the date of incorporation, has perpetual succession and did not change its identity or personality even though the entire share holding of the company changed hands. In another case, Re Noel Tedman Holdings Pty Ltd. (1967) QdR 561. The company had a husband and a wife as its only shareholders. They were also the company's directors. They died in an accident, leaving behind an infant child. After their death the company was still in existence. The problem that arose was, as the shareholders and directors had died, the shares could not be transferred according to the will of the deceased to the infant child. The court thus allowed the personal representative of the deceased to appoint directors of the company, so that these directors could allow the transfer of the shares to

the child. Therefore, the company may even continue to exist despite the death of all its shareholders and directors. It will last until it is deregistered or 'wound up'. Another effect of the incorporation is the common seal.

A Company is an Artificial Person in eyes of Law, it has no soul, and it takes birth by the operation of law and ends its life by the operation of law. Like a natural person, it cannot sign on its own. As still it's an artificial person and as it operates in the world market, there arises some situation where law asks a company to sign by putting its common seal on the documents.

Section 121(1) (a) of the Companies Act 1965 requires every company to have a common seal with its name and company number appearing on it. The common seal is affixed on contracts made by the company (Section 35(4(a))). The manner of affixation is prescribed in the company's articles of association. Usually, a board of directors' resolution is required and it may be affixed in the presence of one director and secretary or another director. A company is also entitled to hold land. However such power is to be read subject to Section 19(2) of the Companies Act 1965 which provides that a company formed for the purpose of providing recreation or amusement or promoting commerce, industry, art, science, religion or any other object not involving trading for profit, shall not acquire land unless it has obtained the prior approval of the minister charged with the responsibility for companies.

Therefore, the property will be treated as the company's own and not the shareholder's even if a person owns all the shares in the company. He does not own the company's property nor does he have any legal or equitable interest in that respect. Here the case of *Macaura Vs Northern Assurance Co.*

Ltd 1925 can be mentioned as an example. Here the court held that no share holders have any right to any item of property owned by the company. As in the case of *Nicoll v. New York & Erie R. R. Co*, Nicoll gave a deed to the New York and Erie Railroad Company of a strip of land across his farm for the right-of-way of the railroad. Later, he wished to regain it from the railway company and brought this action to have the corporation ejected from the possession, on the ground that it did not have power to purchase land, nor to take a deed to the fee. The company was chartered for fifty years, and this, it was claimed, made it impossible for it to take more of a title than a fifty-year interest, while the deed purported to convey the whole ownership, for all time, to the corporation and its successors. It was held that the company was entitled to retain the land.

The Court said, in an opinion by Mr. Justice Parker: " The power to purchase lands, where it is necessary for the other purposes of the corporation, is a power incident at common law to all corporations, unless they were specially restrained by their charters or by statute. It is true, that corporations are in most states, expressly prohibited from holding land that is not used for the corporate business, and corporations, for the purpose of buying and holding real estate, are not often permitted. But one of the general powers of any corporation is the holding, purchasing, and conveying of such real estate as the purposes of the corporation require." Section 16(5) of the Companies Act 1965 also states that members of the company shall be liable to contribute to the assets of the company in the event of being wound up. The liability of the members depends on whether the company is a limited company or an

unlimited company and Section 18(1) requires the company's memorandum of association to stipulate so. A limited company does not mean that the company's liability is limited; it is still liable to fulfil all its obligations. It means that its members' liability to pay the company's debts and obligation is limited. A member of an unlimited company is liable for all debts of the company.

Whether a member of a limited company is liable for the debts of the company depends on whether he has fully paid up on his shares or otherwise, he may be called upon at any time by the company to pay up the unpaid portion. If the company should suffer losses, the shareholder is not liable to contribute any more to the company if he has fully paid for his shares. His actual loss would be the amount he has paid for the shares. Creditors of the company cannot take any action against the members, because the members are separate from the company. In the case of *Re Application by Yee Yut Ee* (1978) 2 MLJ 142, Yee was the secretary of a company that was a wholly-owned subsidiary of an American corporation.

The company had retrenched their staff and dispute arose as to the retrenchment benefits. The matter was brought to the Industrial Arbitration Court where an award was made in the company's absence. As the company did not comply with the award, the Arbitration Court ordered that Yee be personally liable as he had been appointed director by then. The High court held that a director is not liable for the company's debts. In *Fairview Schools Bhd v Indrani Rajaratnam & Ors*, Mahadev Shanker J said that, " Limited companies are formed so that its shareholders are not exposed to unlimited

liability for the company's debt. In exchange for this immunity, share capital is pumped into the company which thus becomes available to the company's creditors."

Veil of Incorporation

Most people decide to create a company rather than holding a sole proprietorship or partnership due to the liability protection factor. This is because a " company veil" will be created between the personal assets of members and shareholders with the company. The veil can also be described like a wall between the company and the members. Anton Behr said that, " Stand behind the veil of incorporation is the principle of limited liability that the court will use to prescribe that a company will be responsible for all the debts that have been incurred instead of its shareholders or members."

This company veil is one of the main advantages of establishing a company as it will provide a liability protection against lawsuits and creditors. In addition, members and shareholders can enjoy limited personal liability up to the capital invested in the company when the company was winding up. However, it is crucial to remember that there are times where there are some exceptional circumstances where the court would ignore the company principle of separate legal entity and strip the company members' and shareholders' limited liability that they enjoy. This is called the " lifting veil of incorporation". Lifting the veil of incorporation is a legal decision which will treat the rights and obligations of a corporation as the rights or liabilities of its owner. The members will be responsible in carrying out their fiduciary duties towards the company. If they act in bad faith, the court will lift the

company veil and they shall have a personal liability. There are two factors that can be shown, whether there is fraud/injustice or there must be a lack of separate existence.

Related cases where the court have lifted the company veil i. In cases where national emergency involved.

Referring to the case of Daimler Co. Ltd v Continental Tyre & Rubber Co happened during the time when England was at war with Germany, Continental sued Daimler for money due in respect of goods supplied. Daimler claimed that the Company was actually owned by German Nationals and paying them was illegal under the Trading with the Enemy Act. The Court lifted the corporate veil to discover if this was so, and found as a fact that it was the Germans who were operating the business. D was therefore successful in its defence. ii. In order to prevent a fraud from being committed

In *Gilford Motors v Horne* [1933], Horne was at one time the Managing Director of Gilford Motors. One of the terms of his employment contract was that, in the event that he leaves the Company, he will not solicit the customers of the Company. Eventually Mr. Horne left the Company and setup his own Company by the name of JM Horne & Co Ltd. through which he had business dealings with the previous Company's clients. Gilford Motors sued Mr. Horne. Horne's claimed that it was not him that was doing the business but the Company and that under Company Law they were two different people.

However the Court was not convinced and lifted the veil of incorporation. In this instance, Mr. Horne was just trying to hide behind a corporate veil to steal business from his former employer. It was held that the Court could lift the veil to determine whether the assets of the company were really owned by them or whether there was an abuse of the principal that a company is a separate legal entity. In the case of Jones v Lipman 1962, Lipman sold Jones a house by a written contract but later refused to complete the sale and wished out of the contract. He formed a company, transferred the house to avoid the transaction to claim that he could no longer sell the house to Jones. The court held that this company was formed as a 'device or sham' to frustrate the sale contract, and an order of specific performance of the sale contract was granted to Jones.

The veil of incorporation has been considered in Trustor AB v Smallbone [2001]. The significance in this case lies in the way counsel for the claimant invited the Court of Appeal to lay down rules as to when the veil of incorporation may be lifted. Smallbone was a director of Trustor AB, a Swedish registered company. Without the consent of the other directors, he transferred large amounts of corporate funds into a company controlled by him, Introchrom Ltd. He then removed some of these funds from Introchrom Ltd's bank account into his own name. Being aware of all the circumstances, Smallbone was found to be jointly liable with Introchrom Ltd for those sums received by him from its bank account. The court then had to consider whether Smallbone was liable for sums paid from that account to other persons.

Summary

In forming a company, promoters will take all the responsibilities to ensure that the process runs smoothly. Promoter owes a fiduciary to the company as long as he is a promoter. He may be one of the directors of the company. The company may sue him if he is making any secret profits. A promoter cannot also claim for reimbursement for his expenses incurred to promote the company unless the company has agreed to do so. Incorporation of a business may bring benefits.

As had been mentioned, once the company is incorporated, it shall become an artificial legal person which is recognized by the law as a separate and distinct entity from its members and shareholders and capable of having its own rights, duties and obligations and it will be able to sue or be sued in its own name. However the strict application of the separate legal entity principle does have its disadvantages. We have seen in Macaura's case where the application of the separate legal personality principle caused hardship to the one who owned almost all the shares of the company and who could not claim for insurance taken under his own name. There are also cases where third parties suffer. Where a company is limited liability company, the creditors will suffer if the company incurs debts, as the shareholders are not liable beyond the amount they have contributed in full for their shares.

Due to some of the undesirable consequences of incorporation, company law recognizes a number of exceptions to the principle of veil of incorporation. Under these exceptional circumstances, the law looks at the situation and

will ignore the separation between the company and its members or officers. This is called lifting the veil. When the court lifts the corporate veil, the members or officers will be made liable for the company's obligations. The corporate veil is lifted under situations provided by statute, and also according to the judicial decision under the common law.

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