The salomon case highlights law company business partnership essay

Law

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\n[/toc]\n \nThe Salomon case is a landmark UK company law case that set precedent for many other UK cases in regards to limited liability. There was a struggle between form and substance; whether to interpret the law literally, as was done in the House of Lords - the requirement of seven members having been met, or whether to consider more its presumed spirit and intention, as was done in the Court of Appeal that stated that the seven members must intend bona fide associated for the purpose of trade.[1]The Lords accepted that if the form of the company was within the letter of the law they would not look behind it to the substance. In equity, where there are flexible principles aimed at achieving justice for both sides in each case, it would have regarded " substance not form" and would not have permitted justice to be withheld just because of a technicality. Formalities that frustrate justice would have been disregarded and a better approach would have been found for the case. Equity enforces the spirit rather than the letter of the law alone and it is evident that in the case of Salmon equity was not in place. In this case, Mr. Salomon used his sole trading business to take advantage of the corporate structure as well as the separate legal entity doctrine which established a separate legal personality for Solomon and Co Ltd, from that of his own legal personality which was at stake when he was a leather and boot

sole trader; and as a result the companies legitimacy was questioned. The Companies Act 1862 required that on registering a company there must be atleast 7 shareholders, which Solomon made sure of by giving his wife and five children one share each of the company. Legally, a company is designed to potentially have a large number of participants and so has a formal constitution outlining its basic organisational and power structure, technically owned by its shareholders and controlled by the directors, however, in the Salomon case both the directors and shareholders were him and his family, his family being passive in any decisions made. In running a company, directors are bound by common law fiduciary duties, the most important of which is to ‘ act in good faith (bona fide) in the best interests of the company as a whole’.[2]This duty has generally been interpreted by the courts to mean acting in the interests of the shareholders; however the Court of Appeal was concerned that the six family members, the company’s shareholders, never intended to take part in the business and only held the shares to fulfill a technicality required by the Companies Act.[3]This having been said, the Court of Appeal agreed with the High Court’s decision against Mr. Salomon, on the grounds that Mr. Salomon had abused the privileges of a corporate structure, in order to gain limited liability which Parliament had intended only to confer on " independent bona fide shareholders, who had a mind and will of their own and were not mere puppets".[4]But they had held that Mr. Salomon was only using the company as an agent and therefore he as principal was liable for debts to unsecured creditors. However, the Lords unanimous ruling in favor of Mr. Salomon, upheld firmly the doctrine of corporate personality as set out in the Companies Act, bringing about the

fundamental concept that the business is a separate entity to its shareholders. There has been great support for the principle of separate legal personality shared amongst academic commentators and has been unbroken in legislative and judicial circles for many years. John Gooley's observation that the separate legal entity doctrine was a " two-edged sword"[5]is a prime example of this. A company is a legal ‘ person’ and as a result, creditors of an insolvent company cannot sue the company’s shareholders for outstanding debts, but can only sue the company itself. In turn, the company’s assets belong to it and not the shareholders thus making the separate legal entity doctrine a two-edged sword, as in the case of Macaura v Northern Assurance Co (1925)[6]where Mr. Macaura sought to make an insurance claim for a policy that insured the timber of the Killymoon estate company, which he had taken out in his name. The court held that even though he held all the shares in the company, ‘ neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation’.[7]The two edged sword makes it so that on the one side the rights of members are limited and on the other side, a creditor’s practical ability to seek redress are limited. Because of this, it has been argued that the Salomon case has promoted fraud and the evasion of legal obligations. Courts and the legislature, as a result, were forced to balance the benefits of incorporation to small private enterprises and its respective rights, to prevent abuse. Nonetheless, the decision in Salomon's case on the complete separation of the company and its members has since, never been doubted.
[8]The original purpose of limited liability was to enable passive investors to put a limited sum of money into a business without risk.[9]‘[S]ome form of

limited liability is essential if the maintenance and continuation of the system of private enterprise as is practiced in advanced industrial capitalist societies is to continue'.[10]For an entrepreneur (or sole trader) like Aron Salomon, creating a company enables him the benefit of protecting his own personal property from the failure of the business. If an entrepreneur dealt as a sole trader, then he would face the risk that all of his own property (his money, his house, his car, and so on) would be lost if the business failed. By organizing his business as a company, the entrepreneur puts distance between his personal property and the company's property, so that only the company's property will be lost if the business fails.[11]People's personal wealth is not at stake if the company were to fall into liquidation; only the capital they have invested in the firm would be at stake. The corporation having a separate legal identity to its shareholders and directors, has its advantages, reason being why one may register their company as a limited liability rather than remaining an unlimited liability company. Within the branch of limited liability there are public limited companies (Plc), where any member of the public can invest in a share of the company over the stock exchange, and private limited companies (Ltd) where the shareholders cannot sell their shares without offering them first to current shareholders; as in the Salomon case. In Ltd companies shares cannot be offered to the general public over a stock exchange, nor can the number of shareholders exceed a fixed figure. Nonetheless the subdivision of shares allows for a very large number of investors to become members of the company whereby their personal assets are not at stake and this in theory makes raising capital easier as individuals may feel more secure in their investments.

[12]Therefore creating a Plc may be an easier way for a company to generate finances without the interest of a bank, though if a bank loan is required, being a Plc does ensure the banks that that they will get their money back with they're interest far more easily, as all that is required is for the company to sell more shares. A major advantage of becoming a limited company, however, is the division of legal personality, the company having its own legal identity from its shareholders. Once the company is registered, its name is protected by law. No-one else can use the same name, or anything deemed to be too similar. A separate legal entity makes it appealing to entrepreneurs as it enables the investing public to share in the profits of an enterprise without having technical knowledge or experience of a specific business's field, as they will not be required to make business decisions. For example, an investor does not need to have insight on telecommunication or engineering to make an investment in ' Apple'. There being a separate legal entity also allows directors to take both reasonable and unreasonable risk as there is limited liability and personal assets are not at stake. Therefore small trade creditors of the company will not ordinarily be able to lay claim against the shareholders or directors in respect of their personal assets. This in turn gives all companies an equal standing ground, as it allows investors to base the value of the company on its market capitalization and its worth of investing in by its share prices, which is determined by its supply and demand. This as a result encourages expansion, innovation, which in turn helps the economy. Rather than having investors base their investments on the wealth of a company's directors and only investing in the companies with the wealthiest directors, in hope that

they may be able to reimburse its shareholders in the case of liquidation. A corporation provides a structure for joint venture, holding family assets as in the Salomon case. A separate legal identity also means that the company can exist beyond the life of its members as they only act as an agent to the company. Thus an entrepreneurs vision and hard work must not die once they pass away, but their legacy can still live on as long as the company does not liquidate. Shares are easily transferable and as a result ownership can be transferred without much hardship. The Salomon case highlights the independent corporate existence of a registered company and how the limited liability principle attached to its works, allows an entrepreneur, such as Salomon, to hide behind the company, attracting small traders to the corporate form not because it represents an effective device with which to raise capital, but rather a way in which small business traders can access an avenue via which to escape the " tyranny of unlimited liability".[13]This principle has allowed potential investors to be fearless in making an investment, and directors to take big risks with the hope of high returns. Nonetheless, if this principle is applied inflexibly, as was the case in Salomon, it can shield parties unreasonably, to the detriment of persons dealing with companies.[14]However, private companies, such as Salomon's, may not view the status of a limited liability as being as advantageous in this context as it would be for a public company. Private companies comprise of very few members and where the majority of the members are also directors of the company, the advantage of limited liability may be artificial because large creditors of the enterprise are likely to demand personal guarantees of the members to secure the repayment of debts. Should the company

become insolvent; the company's human constituents will gain little from having traded the enterprise as a limited liability.[15]Companies benefit from the Corporation tax they pay on their taxable profits. This offers companies a wide range of allowances and tax deductible costs that can be counteracted against a company's profit. Such as giving employees' executive pension that can come out of the company's funds as a legitimate company expense whilst in turn benefitting the company with loyal employees. Other taxation advantages do occur, entrepreneurs may invest in a business knowing that receiving dividends instead of income in the form of a pay packet can be better, as tax on dividends is only 10% and there are no NI charges on them. An investor in a company is also not subject to the higher (personal) tax rate placed on sole traders or partnerships which can reach 40%. Corporations benefit from tax minimizing through income splitting (encouraged by dividend imputation)[16]as seen in the Hobart Bridge Co Ltd v FCT (1951)[17]case. The taxation authorities in the UK have been aware of the potential for group structures to void taxation by moving assets and liabilities around the group. The Companies Act 2006, s399[18]therefore provides that parent companies have a duty to produce group accounts and s409[19]also requires them to be in much detail.[20]Nonetheless, there has been a growing problem with differentiating the company's ownership, from its control. The statutory model has historically assumed a separation of ownership and control.[21]However, in a small company, such as private limited companies, the shareholders and directors will often completely overlap. The same people may also be the employees of the company, as in the case of Lee v Lee's Air Farming (1961)[22]where Mr. Lee wore ' three hats' as a majority

shareholder, sole governing director and an employee. Where there is no separation in ownership from control most of the historical statutory assumptions about the company’s organizational structure will not hold. However, this problem was addressed by the introduction of a ‘ quasipartnership’ as well as the Companies Act 2006 significantly improving the difficulties faced by close companies in using the company.[23]In a limited liability company there are more complex and restrictive rules governing the accounts and bookkeeping than there is as a sole trading business. This is because a limited company doesn’t have the freedom to act as they wish or keep all business information private. The company’s annual accounts are to be kept in the Companies House in order for the members of the public to inspect freely. In this regard, the administration expenses of a company are higher, as company law and resulting administration is far more intricate than that of a sole trader.[24]The resource allocation of a limited liability company may often be viewed as a vehicle of waste because shareholders and directors of the enterprise, with less fear of the incursion of personal loss, may be less demanding and careless in the management of resources, then the controller of an unlimited enterprise. However it is also argued that ‘ limited liability reduces the costs involved in the separation of ownership and control… reduc[ing] the need to monitor management and other shareholders’.[25]In the decades since Salomon's case, various exceptional circumstances have been outlined, both by legislatures and the judiciary, one of which being when courts can legitimately disregard a company's separate legal personality, such as where crime or fraud has been committed. Although Salomon's case is cited in court to this day, it has met

with considerable criticism. For example, Otto Kahn-Freund called the decision " calamitous" in his article published at [1944] 7 MLR 54.[26]In that article, the author also called for the abolition of private companies. There is therefore much debate as to whether the same decision would be reached if the same facts were considered in the modern legal environment, given the House of Lords' decisions in Pepper v Hart [1993][27]and Re Spectrum Plus Ltd [2005][28]and the Privy Council in AG of Belize v Belize Telecom Ltd [2009][29]that require a purposive approach to interpreting legislation. The conclusion that can be drawn is that although the Salomon principle was set over 100 years ago, from latest case law, it appears that the principle of corporate entity from the Salomon case is very much still applied and is the landmark case that is still referred to when referring to the company and its shareholders separate legal personalities substantially contributing, with the Companies Act 2006, in playing an important instrument in company law and business entrepreneurship.

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