The doctrine of separate legal entity: a case of salomon vs salomon and co ltd

Business, Company

Abstract

The doctrine of separate legal entity is a doctrine which has gained increasing importance in the analysis of company law. The importance of this doctrine and its relevance in the analysis of laws relating to companies is evident in the case of Salomon v A Salomon and Co Ltd [1897] AC22, the leading case which gave effect to the separate entity principle (Macintyre 2012).

This case has formed the basis of company law and corporate theory. Not only is this case often quoted in textbooks and journal articles, but also, its principles have found their way to English courtrooms and law firms (Karasz 2012)

Aligning with the above, this paper explains the following statement made by Lord Halsbury in Salomon's case

" Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. C Salomon. If it was not, there was no person and nothing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not" (Roach 2012).

Attempts will be made in this paper to analyze courts' approach to the separate entity principle. Criticism against the decision made by the House of Lords in salomon's case will also be examined. Statutory and judicial exceptions to Salomon shall also be explored on.

Introduction

Corporate theory has certain principles which practitioners and academics have struggled to define. Some of these principles seem somehow unsuitable for strict and permanent delineations given that their construction often change with time (Karasz 2012). The case of Salomon V. Salomon and Co. Ltd which has formed the basis of company law globally is one such example.

Not only is this case often quoted in textbooks and journal articles, but also, its principles have found their way to English courtrooms and law firms (Karasz, 2012). The doctrine of ‘ separate legalpersonality’ laid down in Salomon’s case has received increased recognition and is often cited in court today.

In this paper we explore on the following statement made by Lord Halsbury L. C. in Salomon’s case and analyze the courts’ approach to the separate entity principle.

“ Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. C Salomon. If it was not, there was no person and nothing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not” (Roach 2012).

We will also try to find the basis under which courts may decide to disregard the separate personality of a company. A delve on this topic will not be complete without exploring on Salomon’s case.

Salomon v Salomon & Co Ltd

The case of Salomon v Salomon revolves around Mr. Salomon, a businessman who incorporated his business; and given the requirements put forth in the Companies Act 1862 which require the presence of at least seven shareholders, he made hisfamilymembers as business partners issuing one share to each of them (Keenan & Riches 2009).

The business was bought at ? 39, 000. Mr. Salomon held some 20, 000 shares and since ? 10, 000 was not paid for, he was paid the remaining amount by debentures and granted a floating charge on the company's assets as part payment (Keenan & Riches 2009). Soon after the business had been incorporated, the shoe industry witnessed a series of strike which led to the government's decision to split contracts with several other firms with the aim of diversifying and reducing the risk of its few suppliers, given the ongoing strikes (Keenan & Riches 2009).

Since the company was in need of more funds, they sought ? 5, 000 from Broderip. Salomon's debenture was then assigned to Broderip and secured by a floating charge (Keenan & Riches 2009). In the end, however, the business failed and Broderip sued to enforce his security.

Given that, at the time, the company was indebted to unsecured creditors; an action against the appellant was brought by the company's liquidator and the case tried before Vaughan Williams, J. of the high court (Keenan & Riches 2009). Vaughan Williams J declared Broderip's claim to be valid arguing that the signatories were just but mere dummies and that Mr. Salomon was acting as an agent of the company (Keenan & Riches 2009). Thus the

company was entitled to indemnity from the principal who in this case was Mr. Salomon (Keenan & Riches 2009).

The ruling made by the Court of Appeal further confirmed the earlier decision made by Vaughan William. The Court of Appeal ruled that Broderip’s claim was valid on grounds that the Appellant had abused the privileges of incorporation (Macintyre 2012). According to the Court of Appeal, the incorporation of the company was improper as the Act only contemplated the incorporation of independent bona fide shareholders with the will and minds of their own and not mere puppets (Macintyre 2012)

This decision was, however, unanimously overturned by the House of Lords and the arguments of fraud and agency rejected (Macintyre 2012). They held that the Act had to be the sole guide for determining whether a company had been validly constituted. According to the Companies Act 1862, just a share was enough for one to be named as a member. It was therefore not in order to label shareholders as dummies or mere puppets since the company had been duly constituted by law and thus had a separate legal entity (Macintyre 2012).

The House of Lords remarked that it was improper for the judges to read into the statute limitations based on their personal opinion (Macintyre 2012). The House further noted that while the company remained precisely the same even after being incorporated with the same hands receiving profits; by law, the company was not an agent nor a trustee of the subscribers and the

subscribers were also not liable for any of the company's liabilities (Macintyre 2012).

Since then, legislatures and courts have followed the separate entity principle. This principle which is enshrined in article 16 of the Companies Act 1997 have since been followed in company proceedings in court. Salomon's case has become a landmark company case law in the UK and is often cited in most cases within the area of company law.

The principle established in Salomon vs. Salomon & Co Ltd has stood the test of time, given that this doctrine has formed the basis of company law (Puig 2000). As noted in Salomon's case, a company is at law a legal entity separate from its members and can neither be an agent nor a trustee of the subscribers.

The decision made by the House of Lords in Salomon's case confirms Gooley's observations that the doctrine of separate legal personality was a ' double-edged sword' (Puig 2000). While this decision was good as it promoted capitalism, the decision also extended the benefits of incorporation to private businesses thereby providing for fraud and evasion of legal obligations (Puig 2000). This criticism will be examined in detail in the next section.

Criticism against Salomon's case

Despite having been cited in court, Salomon's case has met considerable criticism. Much of the criticism has been based on the fact that corporate veil

may at times lead to injustice. For example, in the article 7 Modern Law Review 54, Kahn-Freund described the decision made in Salomon’s case as “ calamitous”. Kahn-Freund further called for the abolition of private companies.

Criticism is also mounted against Salomon’s case on the basis that priority is given to the separate identity principle over the economic reality of a one-person company. In the article, The Law Quarterly Review, Goulding explains that criticism laid against Salomon’s case is two-fold. First, the unanimous ruling made by the House of Lords in this case gives incorporators the benefit of limited liability even in situations where it may be deemed unnecessary. Second, this decision affords unscrupulous promoters opportunities to abuse the privileges provided for under the Corporations Act.

Piercing of the corporate veil

Despite the seemingly categorical statement made by Lord Halsbury in Salomon’s case, a few years later, the English court held that in certain situations it was permissible to disregard this principle and to ‘ pierce the corporate veil’ (Mugambwa 2007). In this context, ‘ piercing of corporate veil’ describes situations wherein the separate entity principle may be deemed unfair and the courts may make decisions contrary to this principle on various grounds. The court often does this so as to reach the person behind the veil and to reveal the true nature of the company (Mugambwa 2007)

It has however become a hard task for academics and practitioners to find a basis in which courts may lift the veil. This is an area which is said to be ill-defined, inconsistent and quite unpredictable. In Briggs v James Hardie & Co Pty Ltd, Rogers AJA point out to the lack of a common and unifying principle underlying the court’s decision to lift or ignore the corporate veil (Macintyre 2012).

In determining when to disregard the separate entity principle, commentators have often divided their instances into several distinct categories and often there is no consensus as to the number or type of categories, with some similar cases being placed in different categories. The ultimate policy for lifting the veil also remains elusive with some arguing that it depends on ‘ policy’ while others arguing that it depends on ‘ justice’ (Mugambwa 2007).

Attempts have been made by commentators to categorize cases with the view of predicting the outcome of future cases but this has proved difficult largely due to the fact that this is an area where case facts have significant influence on the outcome. It has also proved difficult to rationalize and categorize cases since this is an area in which the personal views of judges have a bearing on what justifies lifting the corporate veil (Karasz 2012).

Statutory and judicial exceptions

Despite being enshrined in the Companies Act 1997, significant exceptions have been made to the separate entity principle (Macintyre 2012). In other words, there are certain situations in which the courts can legitimately

disregard the separate legal entity principle. According to Bourne (2001), there are two main exceptions to the separate entity principle. These are statutory and judicial exceptions.

In this context, statutory exceptions include provisions that penalize office holders by imposing personal liability. Several statutory provisions have introduced exceptions to the separate legal entity principle. One such statute is the Insolvency Act 1986 which involves fraudulent or rather wrongful trading (Roach 2012). In pursuant to the ‘ fraudulent trading’ provision, if it appears that fraud has been used in carrying out business transactions, the court may on application of the liquidator declare any of the parties to the business liable for making contributions as may be deemed necessary by the court (Roach 2012).

Judicial exceptions, on the other hand, are concerned with the company’s separate legal personality. These exceptions have, however, proven hard to define. Justification for making such exceptions also differs greatly. Sealy & Worthington (2010) gave an example wherein court may make such exceptions. They argued that members can be declared by court liable where their acts constitute them as ‘ principals’ and the company acting as merely an agent.

This example, however, does not encompass all the judicial exceptions. One major group to this type of exception relates to fraud. In thisrespect, Linklater (2006) identifies three cases where fraud had significant influence

on the court's decision to lift the corporate veil: Kensington International Ltd v Congo, R v K and Trustor v Smallbone.

A common feature in all these cases is that they would all have passed Salomon's test that – ' either the limited company was legal entity or it was not' (Linklater 2006). There is, however, one element in all these cases which set them apart from Salomon: the fact that all the three cases were being used for fraud and to disguise the true state of affairs rather than being used for legitimate trading (Linklater 2006).

Another group encompassing judicial exceptions relates to a group structure, wherein both the parent and subsidiary company are viewed as one. This can be seen in the case of Adams v Cape Industries Plc. The court of Appeal ruled that the subsidiary company acted as an agent to the parent company and thus had to be indemnified by the parent company.

Another practical example wherein courts can disregard the doctrine of separate entity can be seen with certain court cases. In UK, courts may disregard Salamon's precedent especially when public funds are at stake. In such cases, courts may decide to impose financial liability on the shareholders and directors of the company.

While these exceptions have been viewed by many as undermining the doctrine of separate legal personality embodied in Salomon's case, it should be noted that these exceptions serve to further define the doctrine by narrowing its scope and stipulating additional guidelines.

Conclusion

There is no doubt that the decision in Salomon's case established the separate legal personality of a company, allowing shareholders to carry on trading with minimal exposure to the risk of personal insolvency in the event of a collapse. There are, however, exceptions to this principle wherein the court may justifiably disregard and make rulings contrary to this principle.

It remains, however, a daunting task for academics and practitioners to find a basis in which the courts may be justified to lift the corporate veil. This is largely due to the fact that this is an area where case facts and personal views of judges have a bearing on the outcome. Nonetheless, the principle in Salomon case is widely recognized and followed in courts. This principle which is enshrined in article 16 of the Companies Act 1997 have since been followed in company proceedings in court. Salomon's case has become a landmark company case law in the UK and is often cited in most cases within the area of company law

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