Company law

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Chapter 1 Introduction

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Introduction

This subject guide acts as a focal point for the study of company law on the external LLB. It is intended to aid your comprehension by taking you carefully through each aspect of the subject. Each chapter also provides an opportunity to digest and review what you have learned by allowing a pause to think and complete activities. At the end of each chapter there are sample examination questions to attempt once you have completed and digested the further reading.

Company law requires students to develop their existing understanding of tort, contract, equity, statutory and common law interpretation. It also provides students with new conceptual challenges such as corporate personality. This combination of development and new challenge can initially be a difficult one for the student. This initial learning period will be greatly eased if you understand the everyday context within which company law issues affect businesses. All of the major national newspapers cover company law issues in their business sections. In an ideal world the company law student would read these sections each day, either by buying a newspaper or going to the library to go through them. However, we do not live in an ideal world so a good compromise is to buy (or read in a library) the Saturday edition of the Financial Times or a national weekend newspaper which has a roundup of the business news each week. This will update the week’s business and general news developments. If you can manage to do this over the academic year it will help to put your learning into context and aid your comprehension of the subject. It may even stimulate your enjoyment of company law!

Learning outcomes

By the end of this chapter and the relevant reading, you should be able to:

- approach the study of company law in a systematic way
- understand what the various elements of the text are designed to do
- begin your study of company law with confidence.
1.1 **Company law**

Company law is about the formation of companies, their continuing regulation during their life and the procedures for dealing with their assets when they are terminated in a liquidation. The state as such plays a major role in company law. However, self-regulation, as we will see, also plays a significant part in the regulation of larger companies and has an important reflection in the theoretical literature.

Company law is one of those subjects that students describe as difficult and lecturers describe as challenging. The difficulty or challenge involved for the student in understanding company law is to overcome the attitude that law is somehow compartmentalised. Most of your previous undergraduate teaching has tended to package subjects neatly – tort, contract, equity, etc. While this provides a nice orderly initial learning experience it is unhelpful for students when they come to subjects like company law where tort, contract, and equity all combine. The result can be an initial disorientation which clears over time. As such, it is important that you have a good knowledge of tort, contract and equity, and understand how the common law works before you tackle this subject.

1.1.1 **Reforming company law**

A major review of company law has recently been completed by the Department of Trade and Industry (DTI) resulting in the introduction of the Company Law Reform Bill 2005 into Parliament. It is very important that any student of company law has extensive knowledge of this project, which began in 1998. The various consultation papers and the Final Report of the DTI's Company Law Review Steering Group (CLRSG) are available at http://www.dti.gov.uk/bbf/co-law-reform-bill/index.html The Final Report forms the basis of the Government's 2002 and 2005 White Papers. These are also available at the same web address, and hard copies will most certainly be available in a good law library or, if you lack access to a library, from the Stationery Office. The proposals of the CLRSG and the Government's response together with the relevant provisions of the Company Law Reform Bill (CLRB) which was introduced into Parliament in November 2005 are discussed where they impact on each individual chapter, but we also expect students to go through these documents themselves. The Bill is expected to be brought into force during 2007. It can be viewed, together with its explanatory notes and amendments, at http://www.publications.parliament.uk/pa/pabills.htm

A good working knowledge of these documents is in our view essential to your success on this company law subject.
1.2 Approaching your study

This guide is designed to be your first reference point for each topic covered on the course. Read through each chapter carefully. The activities occur at points in each chapter where you need to pause and digest the information you have just covered. That means you should stop and think about what you have just learned. Use the activity at this point to aid your reflection. Read it and think generally about the issues it is trying to address.

Feedback on most of these activities is provided at the end of the chapters, but try not to read the feedback immediately. Do this throughout the chapter and when you have completed the chapter move to the essential reading. After this give yourself some time to think about what you have learned or if things are unclear you may need to read over certain points again. Once you have read the chapter and the essential reading attempt in writing the activities in each chapter. Use them as an opportunity to test your understanding of the area. At this point read the feedback provided to see if you are on the right track. Once you have completed this, move to the further reading. Again after completing the further reading give yourself time to think and re-read. Finally, you should attempt the sample examination question at the end of each chapter.

Go through the guide like this covering each chapter in turn. Each chapter builds up your knowledge of the subject and so dipping into the guide as you feel like it will not work. Later chapters presume you have covered and understood the earlier ones. As we explain below you will also have to monitor case developments, reform initiatives and seek out new company law writing to flesh out your understanding of the subject and develop your independence of thought.

1.2.1 Essential reading

Primary textbook


This subject guide is centred on this textbook, which was written by the authors of this guide. References in the text to ‘Dignam and Lowry’ are references to this textbook.

It is your essential reading and so much of your study time should be taken up reading the textbook, though you will also have to study numerous case reports, complete the further reading and keep up to date with academic company law writing.

Other texts to consult


Readings from Davies are specified in each chapter, and like ‘Dignam and Lowry’ this book (‘Davies’) is cited using just the author’s name.

\(^1\) Note that in this subject guide we ask you to do the essential reading AFTER you have worked through the chapter.
Statute books

If you can afford it a statute book is a good addition to your personal company law library. The choice is between:


You are allowed to bring one of these into the examination.

Legal journals

A good company law student is expected to be familiar and up to date with the latest articles and books on company law. Company law articles often appear in the main general UK academic journals:

- Modern Law Review (MLR)
- Oxford Journal of Legal Studies (OJLS)
- Journal of Law and Society (JLS)
- Law Quarterly Review (LQR)

It is essential that you keep up to date with developments reported in these journals. Specific dedicated company or business law journals are also very useful for the company law student. The Company Lawyer, the Journal of Corporate Law Studies and the Journal of Business Law are among the best, combining current academic analysis of issues with updates on case law and statute.

Two important books are drawn to your attention here because of their influence on company law writing. We don’t suggest you buy these texts but rather that you use them in a library (if you can get access to one). The first is J.E. Parkinson’s (1993) Corporate Power and Responsibility: issues in the theory of company law (Oxford, Clarendon Press) [ISBN 0198252889] which examines the corporate law issues surrounding the ‘stakeholder’ debate in the UK (there is more on this in Chapter 17 on corporate governance, but for now it refers to a debate about whether ‘stakeholders’ such as employees and consumers, and issues raised by environmentalists and public interest bodies should be the focus of the exercise of corporate power). John Parkinson also chaired the corporate governance group as part of the Department of Trade and Industry's CLRSG Review of UK company law. His views are therefore important in understanding the CLRSG findings. The second book we would draw your attention to here is Cheffin, B.R. Company Law: theory and structure. (Oxford: Oxford University Press, 1997) [ISBN 0198259735]. The company law and economics school is a growing and influential one in UK company law, and knowledge of it is essential to an understanding of many of the current debates in company law.
Other sources
While company law cases appear in the main law reports there are two dedicated company law reports, *British Company Law Cases* (BCC) (published yearly by Cronor CCH) and *Butterworth's Company Law Cases* (BCLC) edited by D.D. Prentice [ISBN 0406998582], which are very useful.² Online sources such as Westlaw and Lexis also carry these reports as well as unreported cases. You might also find it useful sometimes to dip into texts in a good law library (if you can access one) such as *Palmer's Company Law Manual* [Sweet and Maxwell, ISBN 0421638400] or *Gore-Browne on Companies* [edited by Anthony Boyle, Jordans publishers, ISBN 0853080828]. These are practitioner texts which contain a wealth of up-to-date information.

1.3 The examination

**Important:** the information and advice given in the following section is based on the examination structure used at the time this guide was written. However, the University can alter the format, style or requirements of an examination paper without notice. Because of this, we strongly advise you to check the instructions on the paper you actually sit.

Although there are many ways to achieve examination success the following is our advice on how to deal with company law examinations.

1.3.1 Preparation

No amount of last-minute study will solve the problem of a lack of preparation. You must begin your examination preparation from the first day the course begins. Using this guide as a starting point take careful condensed notes in a loose-leaf file of everything you read. When you have finished a section identify and write down a list of the key points that will act as a memory trigger for you when you return to that section again. While the sample examination questions in this guide are a good way to practise, you should go beyond this and practise answering old LLB examination questions. Be disciplined about this exercise by pretending you are doing it under examination conditions. Give yourself only 45 minutes to answer each question, including reading and planning time.

You should plan out each week of study in advance using a diary allowing at least two hours of study for company law each week. You should also allow time for a review of the week’s work and at the end of the month allow some time for a wider review of what you have achieved in the preceding month. Remember that examinations are not intended to be an accurate assessment of your knowledge of company law. They are a test of your ability to answer certain questions on company law on one particular day in one particular year. As such you need to learn and revise constantly over that year to give yourself the best chance of performing on the day. You also need to be physically and mentally well so make sure you do not overwork; eat well and include social and physical activities in your weekly schedule.

² The ‘essential reading’ for most chapters will include a list of important cases that you should read and make notes on. Where ‘additional cases’ are listed, you should read them if you have time to do so.
Three months before the examination you should draw up an examination revision schedule. At this point you should have been working consistently and have a good set of notes to revise from. You will need now to decide what subjects you will revise for the examinations. This needs careful thought; many students only revise the bare minimum number of questions, which leaves them vulnerable to one or more of these areas not being on the examination or one or more of the areas being combined in one question. It also means the student has little choice even if all four areas come up. One or all of them might be very difficult questions while the other four questions on the paper are easy. For these reasons if you are well prepared at this point you should plan to revise a minimum of six areas but if you wish to be more cautious (there are still no guarantees) revise at least eight areas for the examination after carefully going over the previous examination questions. Again include time in your examination revision schedule for practising old examination questions under examination conditions.

1.3.2 On the day of the examination

If you can, take the night before the examination off and do something relaxing. If you have to revise the night before make sure you finish at a reasonable time and get a good night’s sleep. On the morning of the examination go over your revision notes briefly then put them away and go to the examination without them. You don't need them now if you have done the work, so just try to relax before the examination. Give yourself plenty of time to travel to the examination as you don't need any extra stress on the day.

When the examination starts you will usually have to answer four questions from eight. Read the whole paper question by question very carefully and then decide which questions to attempt. Do not just pick your favourite topic: try to evaluate whether another question is easier to answer even if it is not your favourite topic. Remember, you are trying to maximise your marks. When you have decided which questions to do, draw up a brief plan of how you will answer each question. Then once you have done this you should begin answering the first question.

Timing is very important here: divide up the total allowable examination time into time for reading and planning (5 minutes each question) and time to write the answer (usually 40 minutes). Remember to stick rigidly to this – that means you stop writing immediately the 40 minutes writing time you have allotted is up. If you do not you are throwing marks away. Few students understand this but it is much harder to squeeze marks out of a question you have been answering for 40 minutes than from a new question. By the time 40 minutes is up you will have probably got all the easy marks, and all that is left are the difficult marks. It is much better to stop and start on a new question where there are still lots of easy marks to pick up.

1.3.3 Answering the question

You will by now be sick of being told that your number one aim in the examination is to answer the question. You are told this constantly both because it is true and because failing to abide by
this simple rule is the number one cause of failure in examinations. 
So take this advice seriously – at every point in the examination 
you must ask yourself whether you are answering the question. 
Remember you are almost never asked in an examination to 
provide a general description of an area of law or provide an 
overview of the various arguments for or against a particular point 
of view. Lawyers argue, and that’s what it is all about – not 
unsubstantiated opinion but reasoned argument recognising 
weakness and strength in your own and the opposing argument but 
nevertheless arguing consistently for a particular point. The 
examination format seems to make students forget this.

In general you will encounter two distinct types of questions, 
problem and essay. Problem questions are relatively 
straightforward – you simply apply the law to the facts of the 
question. To do this you look to see what you are being asked in the 
question – this will help you decide what facts are relevant. For 
example if you are asked to ‘advise Fred’ then only information 
which impacts on Fred will be relevant. You then go through each 
line of the question drawing out the relevant facts, applying the law 
to it and answering the question. Essay questions cause more 
difficulty as they provide more scope for a general discussion which 
fails to answer the question. Never, ever, read an examination 
question, identify it as a particular area e.g. ‘Salomon’ or ‘veil lifting’ 
and then simply write an essay covering all you know about 
Salomon or veil lifting. You will fail. Read the question, identify the 
area and analyse the question. Break it down into its constituent 
parts, and really think – ‘what am I being asked here?’ and ‘how can 
I best answer?’. When you decide this try using the words of the 
question in your first sentence as a discipline to focus yourself on 
answering the question.

For example in Chapter 3 you will find the following examination 
question:

| The Salomon decision was a scandalous one which unleashed a tidal wave of irresponsibility into the business community. Discuss. |

You should note that it is not actually a question, rather it is a 
provocative statement followed by an invitation to discuss it. This 
type of question is often interpreted by students as an invitation to 
generally discuss the Salomon principle – but it is not. You are 
being asked to argue for or against this statement. It does not 
matter whether you argue for or against it as long as you 
substantiate your argument with cases, statutes and academic 
commentary and are consistent. So in answering this question you 
should start your essay using the words of the question to indicate 
what you are going to argue. For example:

‘This answer will show that the principle expounded by the House of Lords in Salomon v Salomon was not a scandalous one and in no way did it unleash a tidal wave of irresponsibility into the business community.’

It is not enough to just do this and then provide a general description 
of the area. You must follow the argument through to the end, 
identifying weaknesses and strengths but holding firm to your 
argument. If things are uncertain, as the law often is, then identify the
uncertainty and give your substantiated opinion as to which course the law should take. All the time asking yourself: Am I answering the question? Remember as well that an essay question has a **beginning** (where you introduce your argument), a **middle** (where you set out the detail of your argument) and an **end** (where you conclude by repeating briefly your argument). Always follow this format, as it will help you focus on your argument.

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**Reminder of learning outcomes**

By this stage you should be able to:

- approach the study of company law in a systematic way
- understand what the various elements of the text are designed to do
- begin your study of company law with confidence.

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Good luck!

*Alan Dignam and John Lowry, May 2006*
Chapter 2 Forms of business organisation

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Introduction

Companies are the dominant form of business association in the UK. They are not, however, the only form of business association. Sole traders and partnerships also exist as specific legal forms of business. In this chapter we explore the place of the company within the various types of legal forms of business organisation available in the UK in order to provide some insight as to how the company has come to be the dominant business form. In doing so we will consider the various forms of business organisation from the point of view of their ability to raise capital (money), their ability to minimise risk, and their ability to provide some sort of clear organisational structure. We will also explore some of the general problems that the corporate form poses for businesses.

In general this subject is not a course in the detailed procedural aspects of company law. Having said this, this chapter more than any other in the guide will touch upon procedural matters as they arise in the course of the chapter. This is because key aspects of the procedural nature of setting up a company are very useful for understanding later chapters such as Chapter 5: ‘Company formation’ and Chapter 9: ‘Dealing with insiders’. Some of you may find this procedural detail off-putting, but bear with it, complete the activities and it will pay dividends in the later chapters.

Learning outcomes

By the end of this chapter and the relevant readings you should be able to:

- illustrate the differences between the major forms of business organisation in the UK
- describe the advantages and disadvantages of each form of business organisation
- explain the different categories of company
- demonstrate the difficulties small businesses have with the company as a form of business organisation.
2.1  The sole trader

A sole trader is a very simple legal form of business. As such there is very little for us to discuss here beyond its advantages and disadvantages. It is, as the name suggests, a one-person business.

**Advantages**

No legal filing requirements or fees and no professional advice is needed to set it up. You just literally go into business on your own and the law will recognise it as having legal form. Simplicity – one person does not need a complex organisational structure.

**Disadvantages**

The disadvantages are that it is not a particularly useful business form for raising capital (money). For most sole traders the capital will be provided by personal savings or a bank loan.

Unlimited liability – the most important point to note in terms of comparing this form to the company is that there is no difference between the sole trading business and the sole trader himself. The profits of the business belong to the sole trader but so do the losses. As a result he has personal liability for all the debts of the business. If the business collapses owing money (an insolvent liquidation – see Chapter 16) then those owed money by the company (its creditors) can go after the personal assets of the sole trader (e.g. his or her car or house) in order to get their money back.

**Self-assessment question**

From the point of view of raising capital, minimising risk and providing an organisational structure, assess the merits of a sole trading concern.

2.2  The partnership

The partnership is the next step in terms of facilitating the growth of a business. Partnerships are very flexible legal business forms. While we are more familiar with complex partnerships in the form of law firms and accountancy firms, partnerships can also be very simple affairs. The Partnership Act 1890, s.1 defines a partnership as ‘the relationship which subsists between persons carrying on a business in common with a view of profit’. This is a very broad category and sometimes causes problems (see disadvantages below).
Advantages

No formal legal filing requirement involved in becoming a partnership beyond the minimum requirement that there be two members of the partnership. Once there are two people who form the business it will be deemed a legal partnership. It facilitates investment as it allows two or more people to pool their resources. The maximum number of partners allowable is since 2002 unlimited. Prior to that it was 20 unless you were a professional firm – solicitors, accountants etc.

If you are aware of the problems the Partnership Act can cause (see disadvantages below) then you can draft a partnership agreement to vary these terms of the Act and provide an accurate reflection of your intentions when entering the partnership. The partnership agreement can therefore be used to provide a very flexible organisational structure although this usually involves having to pay for legal advice.

Disadvantages

The Partnership Act 1890 can be a danger to the unwary. The broad definition of a partnership is a particular problem. For example three people going into business together without forming a company will be partners whether they know it or not. This can cause problems, as the Partnership Act 1890 imposes certain conditions for the continued existence of the partnership. If one of our three unknowing partners dies the Partnership Act will deem the partnership (even though the participants did not know they were partners) to have ended. This is the case even where a successful business is being operated through the partnership. As a result of these types of problems those who choose to be partners will usually draft a more formal arrangement called a partnership agreement specifying the terms and conditions of the partnership. The Act also entitles each partner:

- to participate in management
- to an equal share of profit
- to an indemnity in respect of liabilities assumed in the course of the partnership business
- not to be expelled by the other partners.

A partnership will end on the death of a partner. If you are unaware of this when the partnership is formed, the rigidity of the Act may not reflect the intention of the partners.

The partners are jointly and severally liable for the debts of the partnership. This means that each partner can be sued for the total debts of the partnership. In essence, partnerships are founded on relationships of trust. If that trust is breached then the remaining partner or partners can pay a heavy price as the remaining partner must pay all the debts owed. However, if that relationship of trust is maintained then the partnership effectively reduces the risk of doing business compared to a sole trader by having other partners to share the risk with.
Self-assessment question

From the point of view of raising capital, minimising risk and providing an organisational structure assess the merits of a partnership.

2.3 The company

A company is formed by applying to the registrar of companies, providing a constitution (essentially a set of rules for the company similar to a public law conception of a constitution, see below), the names of the first directors and members plus a small fee. This formation process is called incorporation. The registered company has become the dominant legal business form in the UK. The reasons for this are not as obvious as one might assume, as we will explore in this section.

2.3.1 Categories of company

Company law is mainly concerned with the company limited by shares (that is a company where the liability of the shareholders for the debts of the company is limited to the amount unpaid on their shares). There are also companies limited by guarantee. These companies were designed for charitable or public interest ventures where no profit is envisaged. As a result the people behind the venture guarantee to pay a certain amount towards the debts of the company should it fail. Companies limited by shares are also subdivided into public and private companies limited by shares.

Differences between public and private companies limited by shares

Before 1992 you needed two shareholders to form a private company limited by shares. The Twelfth EC Company Law Directive (89/667) changed this requirement and the Companies Act now provides for single person private companies. Public companies still need two shareholders.

In private companies investment comes either from the founding members in the form of personal savings or from a bank loan. As such, private companies are prohibited from raising capital from the general public.

Public companies, on the other hand, are formed specifically to raise large amounts of money from the general public.

Private companies can restrict their membership to those the Directors approve of or insist that those who wish to leave the company first offer their shares to the other members. Public companies could also do this but as their aim is to raise money from the general public a restriction on the sale of shares would not encourage the general public to invest.

Public companies have a minimum capital requirement of £50,000 (CA 1985, s.118). That capital requirement does not have to be fully paid – it just needs one quarter of the £50,000 to be paid and an ability to call on the members for the remaining amount (CA 85, s.101). Private companies have no real minimum capital requirements. For example a private company can have an authorised share capital of £1 subdivided into shares of 1p each. Because public companies raise capital from the general public there is a raft of extra
regulations that affect their activities. This is discussed extensively in Chapter 6 on raising equity.

Private companies can also adopt an elective regime (CA 1985, s.379A) which is designed to recognise that often in private companies the Directors and the members of the company are one and the same and so requirements for meetings, timing of meetings and laying of accounts can be suspended to streamline the operation of the private company (CA 1985 Table A, art.53 also allows a more informal decision-making process).

**Limited liability**

One of the most obvious differences between the company and other forms of business organisation is that the members of both private and public companies have limited liability. This means that the members of the company are only liable for the amount unpaid on their shares and not for the debts of the company. We will explore how this operates in some detail in the next chapter. In order to warn those who might deal with a company that the members have limited liability the word ‘limited’ or ‘Ltd’ must appear after a private company’s name or ‘plc’ after a public company (CA 1985, s.1(3) and s.25(1)).

**2.3.2 The constitution of the company**

As part of the registration procedure both public and private companies must provide a constitution which sets out the powers of the company and allocates them to the company’s organs, usually the general meeting and the Board of Directors. This constitution consists of two documents: the Memorandum of Association and the Articles of Association. The Company Law Reform Bill 2005 proposes having a single document that replaces the current constitution (see Chapters 9 and 14).

**The memorandum**

The memorandum is addressed to the general public and contains the company name, its share capital, the address of its registered office, the objects of the company and a statement that the liability of its members is limited. A private company needs at least one person to subscribe to the memorandum and a public company two people. The subscribers agree to take some shares or share in the company and become its first shareholders.

The memorandum contains three important aspects of company law:

- It announces the limited liability of the members. While we have briefly touched on this above we will return to this important topic in the next chapter.
- It sets out the **objects** of the company, i.e. it states what the company has been formed to do. This was once a very complex area of study for company lawyers because of the tendency of companies to change the nature of their business without changing – or because they were unable to change – their objects clause. Thankfully for us all it has been the subject of a largely successful and ongoing reform programme. The Company Law Reform Bill 2005 proposes companies will automatically have unlimited capacity. Companies can choose
to have a restrictive objects clause if they wish but in general
the objects clause issue should recede further. However it still
forms an important part of company law and we will discuss it
extensively in Chapter 13.

The share capital in the memorandum is known as the
nominal or authorised share capital. It represents the amount
of share capital that could be issued to investors. Once an
amount has been issued to investors that amount is called the
issued share capital. The memorandum will also state the
amounts that the authorised share capital is subdivided into,
for example £100 subdivided into shares of £1 each. The value
given to each share is known as its 'par' or 'nominal' value.
Shares can be fully paid, partly paid or even unpaid. With
partly and unpaid shares the shareholder can be called upon to
pay for them at a later date. Shares may also be paid for in
goods and services and not necessarily in cash. We will discuss
share capital extensively in Chapter 8.

**The articles of association**

The articles of association are a set of rules for running the
company. They set out the heart of any company's organisational
structure by allocating power between the Board of Directors (the
main management organ) and the general meeting (the main
shareholder organ). Those forming a company can provide their
own articles but if they do not a model set of articles (Table A) is
provided by the CA 1985 (SI 1985, 805) and will apply. Table A is
generally adopted with some slight amendments. The articles can
be altered if three-quarters of the members (by a special resolution)
vote to do so (CA 1985, s.9). Additionally the CA 1985, s.303 gives
members the right by simple majority (more than 50 per cent of the
shareholders who vote, vote for the resolution) to remove a
Director for any reason whatsoever. Therefore while the Board is
the primary management organ under the constitution it is subject
to the continuing approval of the shareholders in general meeting.

**Advantages**

Companies are designed as investment vehicles. Companies
have the ability to subdivide their capital into small amounts,
allowing them to draw in huge numbers of investors who also
benefit from the sub-division by being able to sell on small
parts of their investment.

Limited liability also minimises the risk for investors and is
said to encourage investment. It is also said to allow managers
to take greater risk in the knowledge that the shareholders will
not lose everything.

The constitution of the company provides a clear
organisational structure which is essential in a business
venture where you have large numbers of participants.

**Disadvantages**

Forming a company and complying with company law is
expensive and time consuming.

It also appears to be an inappropriately complex organisational
form for small businesses, where the Board of Directors and
the shareholders are often the same people (we discuss this
further below).
Chapter 2 Forms of business organisation

Self-assessment

(a) What are the advantages and disadvantages of each form of business organisation?

(b) With a view to recommending a particular form of business organisation to a client wishing to set up a cyber-café compare and contrast each of the types discussed above.

(c) Explain the difference between a private and a public company.

Reminder of learning outcomes

By this stage you should be able to:

- illustrate the differences between the major forms of business organisation in the UK
- describe the advantages and disadvantages of each form of business organisation
- explain the different categories of company.

2.4 Some general problems with the corporate form

The dominance of the corporation as the preferred mechanism for organising a business in the UK has thrown up some important problems for company law. The problems stem from the ‘one size fits all’ nature of the corporate form. While there is the distinction between public and private registered companies, that distinction masks the fact that the basic legal model provided for public and private companies is very similar. As a result the statutory framework is applied to one-person private companies and large public companies as if they were similar in nature. The problem is that they are not.

The key difficulty arises because the statutory model assumes a separation of ownership from control. That is it assumes that the investors are residual controllers exercising control once a year at the annual general meeting (AGM) and that the day-to-day management of the business is carried out by professional managers (Directors). For large companies this is the case but for the vast majority of companies in the UK this separation of ownership from control does not exist (see Chapter 14).

To illustrate this we need to examine how company law presumes the ownership and control system within the statutory model operates for both a large and a small company.

2.4.1 A large company

The general meeting meets once a year (this is the Annual General Meeting or AGM) primarily to elect the Directors to the Board.

The Directors will be a mix of professional managers (executive Directors) and independent outsiders (non-executive Directors); see Chapter 14.
The Executive Directors will normally have a small shareholding but not usually a significant one.

The shareholders are also provided with an Annual Report from the Directors outlining the performance of the company over the past year and the prospects for the future (like a sort of report card on their performance). At the heart of the report are the accounts certified by the auditor (an independent accountant who checks over the accounts prepared by the Directors).

In between AGMs the Directors run the company without any involvement by the shareholders.

In a large company the Board of Directors will be more like a policy body which sets the direction the company goes in, but the actual implementation of that direction will be carried out by the company’s employees.

The Directors in carrying out their function stand in a fiduciary1 relationship with the company. They therefore owe a duty to act bona fides in the interests of the company (this generally meaning the shareholders’ interests) and not for any other purpose (such as self-enrichment – see Chapter 14).

The employees who are authorised to carry out the company’s business are the company’s agents and therefore the company will be bound by their actions (see Chapter 13).

2.4.2 A small company

The same company law model applies to a small company but with significant differences in effect.

The shareholders and Directors will often be the same people.

The same people will also be the only employees of the company.

There is no separation of ownership from control, the shareholders are the managers, and therefore most of the statutory assumptions about the company’s organisational structure will not hold.

As a result of these differences, in effect the requirements for meetings and accounts – which are based on a presumption of the managers being different people from the shareholders – become a burden for small companies.

2.4.3 The Freedman study

In an extremely interesting study Freedman (1994) found that 90 per cent of all companies in the UK were small private concerns. She also surveyed small businesses as to the advantages and disadvantages of forming and running a company.

Disadvantages

Burdensome regulatory requirements (meetings, accounts, etc.).

Expensive as they had to pay for professional advice to deal with the regulatory requirements.

1 A fiduciary is a person who is bound to act in the interests and for the benefit of another; trustees also have fiduciary duties.
Advantages

Prestige. The small businesses surveyed considered that one of the major advantages (in fact possibly the only advantage) of forming a company was that it conferred prestige, legitimacy and credibility on the venture.

One assumed advantage to the small business – that of limited liability – was also negated by the practice of banks requiring the shareholders to provide guarantees for bank loans (a common source of finance among small businesses). Thus any debts owed to the banks could be reclaimed from the personal assets of the shareholders if the company was in insolvent liquidation.

Solutions

Company law has not been blind to this problem and some concessions have been made. In particular, as we noted above when comparing private and public companies, a private company could adopt the simplified elective regime in CA 1985, s.379A which allows the suspension of meetings, timing of meetings and laying of accounts. A small private company may also adopt a written regime under the Table A articles of association, art.53 which allows a more informal written decision-making process. However these concessions were largely seen as inadequate and the CLRSG’s Final Report (Modern Company Law for a Competitive Economy: Final Report (2001), Chapters 2 and 4) recommended that the statutory requirements for decision-making, accounts and audit, constitutional structure, and dispute resolution be simplified for small businesses.

As we will discuss in Chapter 14, the need to focus company law on the small business was a major theme (if not the major theme of the CLRSG’s Final Report). As a result the CLRSG also recommended that legislation on private companies should be made easier to understand. In particular there should be a clear statement of the duties of Directors. The 2002 White Paper Modernising Company Law: The Government’s Policy that followed the CLRSG Final Report, the March 2005 White Paper and the Company Law Reform Bill 2005 have all carried through this focus on the ‘quasi-partnership’ company with its ‘think small first’ emphasis.

Minority issues

The fact that there are so few participants in a small business presents another problem for company law. That is, sometimes they disagree and if this continues a minority shareholder can easily be excluded from the running of the company while remaining trapped within the company. This occurs because company law presumes that the company operates through its constitutional organs. In order for the company to operate either the Board of Directors makes a decision or if it cannot then the general meeting can do so. It can, however, happen that a majority of shareholders holding 51 per cent (simple majority voting power) of the shares in the company could act to the detriment of the other 49 per cent. A 51 per cent majority would allow those members to elect only those who support their policies to the Board. Thus the 49 per cent shareholder would be unrepresented on the Board and powerless in the general meeting.
These situations are worse in private companies where the minority shareholder often needs Board approval for the sale of shares to an outsider or must offer the shares to the other members first. If the other members are obstructive then this pre-emption process can leave the minority shareholders trapped. Of course the fact that the majority holder is behaving badly will make it difficult to find a buyer willing to put themselves into a similarly weak position. Although the courts quickly came up with a limited exception to enforcing the constitutional structure (see Chapters 11 and 12) there has been a continuing tension between enforcing the constitutional structure (allowing Directors to run the company unimpaired by factions among the shareholders) and protecting minority shareholders against genuinely fraudulent transactions (see Chapter 10). Eventually a statutory remedy was introduced (CA 1985, s.459) to make it easier for shareholders to bring an action.

Self-assessment question

From the point of view of raising capital, minimising risk and providing an organisational structure assess the merits of a registered company.

Activity 2.1

Is the corporate form suitable for small companies?

Feedback: see page 24.

Summary

The importance of this chapter is that it forms a context within which we can place the company and its success as a business form. The Sole trader may be a suitable approach for informal one-person ventures where the capital is mostly provided by the sole trader’s savings or a bank loan. It is unsuitable for larger organisational or investment purposes. The partnership is a very good business form which has many advantages over a company, particularly for small and medium-sized businesses. Unfortunately it has fallen out of use as a significant business form. The increase in the number of partners allowed may go some way to increase its popularity. The company in turn has come to dominate.

However the company as a form of business organisation is not without its problems. The company is designed as an investment vehicle, with limited liability for its shareholders and a clear organisational structure; it is designed for ventures where there is an effective separation of ownership from control and thus is largely unsuitable for the majority of its users who are small businesses. In many ways the partnership would be more suitable for an entrepreneur and less onerous for small businesses generally especially given that limited liability is rarely a reality for these types of businesses. However, the continued use of the corporate form by small companies seems secure given the prestige attached to the tag ‘Ltd’. The Company Law Reform Bill 2005 will go some way to facilitating the needs of small businesses when it becomes law in 2007.
Further reading


Reminder of learning outcomes

By this stage you should be able to:

- demonstrate the difficulties small businesses have with the company as a form of business organisation.

Sample examination question

In what way does company law facilitate the small business and is it adequate?

Advice on answering the question

The key points to cover in your answer are these:

(a) the distinction company law makes between public and private companies

(b) the elective regime in the CA 1985, s.379A

(c) the concessions provided by Table A, art.53

(d) minority protection concessions for small businesses, and the fact that the CLRSG and the Company Law Reform Bill 2005 thinks this protection is inadequate

(e) a discussion of the CLRSG’s and the Company Law Reform Bill 2005 proposals.
Feedback to activities: Chapter 2

Activity 2.1 Small businesses seem to have been particularly ill served by the corporate form. At the heart of this has been the difference between company law’s presumption that the shareholders do not exercise day-to-day control of the business, and the reality in a small business that shareholders do exercise day-to-day control. The elective regime in the CA 1985 and Table A does try to simplify matters, but still from the Freedman study we know that the only real advantage perceived by small businesses from forming a company was the legitimacy it conferred on the business. The CLRSG Final Report and the White Paper which followed attempts to redress this imbalance by removing the presumption that ownership is separated from control in order to make the corporate form a better model for small businesses.
Chapter 3 The nature of legal personality

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Introduction

In this chapter we explore the related concepts of corporate legal personality and limited liability. These concepts are central to your developing understanding of company law and it is essential that you take time here to absorb these fundamental principles.

Learning outcomes

By the end of this chapter and the relevant readings, you should be able to:

  explain what is meant by ‘corporate legal personality’
  illustrate the key effects of corporate legal personality in relation to liability.

Essential reading

Dignam and Lowry, Chapter 2: ‘Corporate personality and limited liability’.
Davies, Chapter 2: ‘Advantages and disadvantages of incorporation’ and Chapter 8: ‘Limited liability and lifting the veil at common law’.

3.1 Corporate personality

Corporate personality refers to the fact that as far as the law is concerned a company really exists. As a result of this, a company can sue and be sued in its own name, hold its own property and – crucially – be liable for its own debts. It is this concept that enables limited liability for shareholders to occur as the debts belong to the legal entity of the company and not to the shareholders in that company.

The history of corporate personality

Corporate legal personality arose from the activities of organisations such as religious orders and local authorities which were granted rights by the government to hold property and sue and be sued in their own right and not to have to rely on the rights of the members behind the organisation. Over time the concept began to be applied to commercial ventures with a public interest element such as rail building ventures and colonial trading businesses. However, modern company law only began in the mid-nineteenth century when a series of Companies Acts were passed which allowed ordinary individuals to form registered companies with limited liability. The way in which corporate personality and limited liability link together is best expressed by examining the key cases.

3.2 Salomon v Salomon & Co.

It was fairly clear that the mid-nineteenth century Companies Acts intended the virtues of corporate personality and limited liability to be conferred on medium to large commercial ventures. To ensure this was the case there was a requirement that there be at least seven members of the company. This was thought to exclude sole traders and small partnerships from utilising corporate personality. However, as we will see below in the case of Salomon v Salomon & Co. [1897] AC 22, this assumption proved to be mistaken.

Mr Salomon carried on a business as a leather merchant. In 1892 he formed the company Salomon & Co Ltd. Mr Salomon, his wife and five of his children held one share each in the company. The members of the family held the shares for Mr Salomon because the Companies Acts required at that time that there be seven shareholders. Mr Salomon was also the Managing Director of the company. The newly incorporated company purchased the sole trading leather business. The leather business was valued by Mr Salomon at £39,000. This was not an attempt at a fair valuation; rather it represented Mr Salomon’s confidence in the continued success of the business. The price was paid in £10,000 worth of debentures (a debenture is a written acknowledgement of debt like a mortgage – see Chapter 7) giving a charge over all the company’s assets (this means the debt is secured over the company’s assets and Mr Salomon could, if he is not repaid his debt, take the company’s assets and sell them to get his money back), plus £20,000 in £1 shares and £9,000 cash. Mr Salomon also at this point paid off all the sole trading business creditors in full. Mr Salomon thus held 20,001 shares in the company, with his family.
holding the six remaining shares. He was also, because of the debenture, a secured creditor.

However, things did not go well for the leather business and within a year Mr Salomon had to sell his debenture to save the business. This did not have the desired effect and the company was placed in insolvent liquidation (i.e. it had too little money to pay its debts) and a liquidator was appointed (a court appointed official who sells off the remaining assets and distributes the proceeds to those who are owed money by the company, see Chapter 16). The liquidator alleged that the company was but a sham and a mere ‘alias’ or agent for Mr Salomon and that Mr Salomon was therefore personally liable for the debts of the company. The Court of Appeal agreed, finding that the shareholders had to be a bona fide association who intended to go into business and not just hold shares to comply with the Companies Acts.

The House of Lords disagreed and found that:

- the fact that some of the shareholders are only holding shares as a technicality was irrelevant; the registration procedure could be used by an individual to carry on what was in effect a one-man business
- a company formed in compliance with the regulations of the Companies Acts is a separate person and not the agent or trustee of its controller. As a result, the debts of the company were its own and not those of the members. The members’ liability was limited to the amount prescribed in the Companies Act – i.e. the amount they invested.

The decision also confirmed that the use of debentures instead of shares can further protect investors.

**Activity 3.1**

Read *Salomon v Salomon & Co.* (1897) AC 22.

**(a)** Describe the key effects of the change in status from a sole trader to a limited company for Mr Salomon.

**(b)** What are the key principles that we can draw from the case?

**(c)** Should Mr Salomon have been liable for the debts of the company?

*Feedback: see page 31.*
3.3 Other cases illustrating the *Salomon* principle

3.3.1 *Macaura*

The principle in *Salomon* is best illustrated by examining some of the key cases that followed after. In *Macaura v Northern Assurance Co.* [1925] AC 619 Mr Macaura owned an estate and some timber. He agreed to sell all the timber on the estate in return for the entire issued share capital of Irish Canadian Saw Mills Ltd. The timber, which amounted to almost the entire assets of the company, was then stored on the estate. On 6 February 1922 Mr Macaura insured the timber in his own name. Two weeks later a fire destroyed all the timber on the estate. Mr Macaura tried to claim under the insurance policy. The insurance company refused to pay out arguing that he had no insurable interest in the timber as the timber belonged to the company. Allegations of fraud were also made against Mr Macaura but never proven. Eventually in 1925 the issue arrived before the House of Lords who found that:

- the timber belonged to the company and not Mr Macaura
- Mr Macaura, even though he owned all the shares in the company, had no insurable interest in the property of the company
- just as corporate personality facilitates limited liability by having the debts belong to the corporation and not the members, it also means that the company's assets belong to it and not to the shareholders.

More modern examples of the *Salomon* principle and the *Macaura* problem can be seen in cases such as *Barings Plc (In Liquidation) v Coopers & Lybrand (No.4)* [2002] 2 BCLC 364. In that case a loss suffered by a parent company as a result of a loss at its subsidiary (a company in which it held all the shares) was not actionable by the parent – the subsidiary was the proper plaintiff. In essence you can’t have it both ways – limited liability has huge advantages for shareholders but it also means that the company is a separate legal entity with its own property, rights and obligations. (See also *Giles v Rhind* [2003] 2 WLR 237 and *Shaker v Al-Bedrawi* [2003] 2 WLR 922).

3.3.2 *Lee*

Another good illustration is *Lee v Lee's Air Farming* [1961] AC 12. Mr Lee incorporated a company, Lee's Air Farming Limited, in August 1954 in which he owned all the shares. Mr Lee was also the sole ‘Governing Director’ for life. Thus, as with Mr Salomon, he was in essence a sole trader who now operated through a corporation. Mr Lee was also employed as chief pilot of the company. In March, 1956, while Mr Lee was working, the company plane he was flying stalled and crashed. Mr Lee was killed in the crash leaving a widow and four infant children.

The company as part of its statutory obligations had been paying an insurance policy to cover claims brought under the Workers’ Compensation Act. The widow claimed she was entitled to compensation under the Act as the widow of a ‘worker’. The issue went first to the New Zealand Court of Appeal who found that he was not a ‘worker’ within the meaning of the Act and so no...
compensation was payable. The case was appealed to the Privy Council in London. They found that:

the company and Mr Lee were distinct legal entities and therefore capable of entering into legal relations with one another

as such they had entered into a contractual relationship for him to be employed as the chief pilot of the company

he could in his role of Governing Director give himself orders as chief pilot. It was therefore a master and servant relationship and as such he fitted the definition of ‘worker’ under the Act. The widow was therefore entitled to compensation.

Activity 3.2

(a) Read Macaura v Northern Assurance Co. (1925) AC 619 and Lee v Lee’s Air Farming (1961) AC 12 carefully and then write a brief 300-word summary of each case.

(b) Re-read Dignam and Lowry, Chapter 2, paras 2.2–2.12 and paras 2.32–2.44.

Feedback: see page 31.

3.4 Limited liability

As we showed above, separate legal personality and limited liability are not the same thing. Limited liability is the logical consequence of the existence of a separate personality. The legal existence of a company (corporation) means it can be responsible for its own debts. The shareholders will lose their initial investment in the company but they will not be responsible for the debts of the company. Just as humans can have restrictions imposed on their legal personality (as in the case of children) a company can have legal personality without limited liability if that is how it is conferred by the statute. For example, a company may still be formed today without limited liability as a registered unlimited company (CA 1985, s.1(1)).

Summary

There are some key points to take from this chapter. First, it is important at this stage that you grasp the concept of corporate personality. If at this stage you do not, then take some time to think about it and when you are ready come back and re-read Dignam and Lowry, Chapter 2, paras 2.2–2.12. Second, having grasped the concept of corporate personality you also need to understand its consequences – i.e. the fact that the company can hold its own property and be responsible for its own debts.
Useful further reading


Reminder of learning outcomes

By this stage you should be able to:

- explain what is meant by ‘corporate legal personality’
- illustrate the key effects of corporate legal personality.

Sample examination question

The *Salomon* decision was a scandalous one which unleashed a tidal wave of irresponsibility into the business community.

Discuss.

Advice on answering this question

Start by setting out your position on this provocative statement. Do you agree with it or not? Either way you must take a position and argue it consistently. There are two parts to the statement – (1) is it scandalous? and (2) did it unleash a ‘tidal wave of irresponsibility’? Make sure you address the points separately and tie them together in your conclusion.

Go through the facts of *Salomon* with particular emphasis on the aspects of the case that might be scandalous, i.e. Mr Salomon’s evasion of personal liability for the debts of his one man company and his over-valuation of the business.

Discuss whether a ‘tidal wave of irresponsibility’ was unleashed into the business community. Points to make here are that creditors may lose out but investment and management risk-taking is facilitated.
Feedback to activities: Chapter 3

Activity 3.1 (a) Mr Salomon’s personal liability for the debts of the business had changed completely from unlimited liability as a sole trader to limited liability as a shareholder in the company. Not only was Mr Salomon not liable for the debts of the company but he had also as Managing Director of the company granted himself a secured charge over all the company’s assets. As a result if the company failed not only would Mr Salomon have no liability for the debts of the company but whatever assets were left would be claimed by him to pay off the company’s debt to him.

(b) There is really one central principle we can draw and two minor ones. The central principle is that the company is a separate legal personality from its members and therefore legally liable for its debts. This brings us to the minor principles. The first being that once the technicalities of the Companies Act are complied with, a one person company can have the benefits of corporate legal personality and limited liability. The second is that debentures can be used effectively to further shield investors from losses.

(c) This is really a matter of your own personal opinion. It is useful however to work out what you think about this issue as it will help you deal with other areas of company law where the Salomon decision has implications.

Activity 3.2 The key point here for your further understanding is that a share is in no way a representation of the fractional value of the company’s property. The company as a separate legal entity owns its own property and there is no legal connection between a share in the company and the company’s property. That is the case even where (as in Macaura and Lee) the shareholder owns all the shares. Shareholders generally benefit from this (although not Mr Macaura) because it facilitates limited liability as the company also owns its own debts (see also Woolfson v Strathclyde Regional Council [1978] SC 90).
Chapter 4 Lifting the veil of incorporation

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Introduction

As we observed in Chapter 3 the application of the *Salomon* principle has mostly (remember Mr Macaura) beneficial effects for shareholders. The price of this benefit is often paid by the company's creditors. In most situations this is as is intended by the Companies Acts. Sometimes, however, the legislature and the courts have intervened where the *Salomon* principle had the potential to be abused or has unjust consequences. This is known as 'lifting the veil of incorporation'. That is the courts or the legislature have decided that in certain circumstances the company will not be treated as a separate legal entity. In this chapter we examine the situations where the legislature and the courts 'lift the veil'.

Learning outcomes

By the end of this chapter and the relevant readings, you should be able to:

- describe the situations where legislation will allow the veil of incorporation to be lifted
- explain the main categories of veil lifting applied by the courts.

Essential reading

Dignam and Lowry, Chapter 3: 'Lifting the veil'.

Davies, Chapter 8: 'Limited liability and lifting the veil at common law' and Chapter 9: 'Statutory exceptions to limited liability'.

4.1 **Legislative intervention**

While the legislature has tempered the effects of the *Salomon* principle in a wide range of areas such as taxation and employment, the main legislative interventions in company law are contained in ss.213 and 214 of the Insolvency Act 1986.

4.1.1 **Insolvency Act, s.213**

Section 213 of the Insolvency Act was designed to deal with situations where the corporate form was used as a vehicle for fraud. It is known as the ‘fraudulent trading’ provision. If in the course of the winding up of a company it appears to the court that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, those individuals can be called upon to contribute to the debts of the company. In *Re Todd Ltd* [1990] BCLC 454, for example, a Director was found liable to contribute over £70,000 to the debts of the company because of his activities. There is also the possibility that criminal liability could follow on with a term of imprisonment as the ultimate penalty. While the criminal penalty was intended to act as a strong deterrent to fraudulent behaviour it proved to have the unfortunate effect of neutralising the effectiveness of s.213 as the courts set a very high standard of proof for ‘intent to defraud’ because of the possibility of a criminal charge also arising. In *Re Patrick & Lyon Ltd* [1933] Ch 786, this involved proving ‘actual dishonesty, involving, according to current notions of fair trading among commercial men, real moral blame’. This standard proved very difficult to obtain in practice and in order to deal with the problem a new provision was introduced in s.214 of the Insolvency Act 1986 to deal with the lesser offence of ‘wrongful trading’.

4.1.2 **Insolvency Act, s.214**

Wrongful trading does not require proving an intent to defraud. Rather it simply requires that a Director at some time before the commencement of the winding up of the company, knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, but continued to trade. The section operates on the basis that at some time before the company entered insolvent liquidation there will have been a point where the Directors knew it was hopeless and the company could not trade out of the situation. The reasonable Director would not at this point continue to trade. If he does continue to trade he risks having to contribute to the debts of the company under s.214.
In *Re Produce Marketing Consortium Ltd (No. 2) (1989) 5 BCC 569* over a period of seven years the company slowly drifted into insolvency. The two Directors involved did nothing wrong except that they did not put the company into liquidation after the point of no return became apparent and so were liable under s.214 to contribute £75,000 to the debts of the company.

Sections 213 and 214 differ in the way they affect the *Salomon* principle. Section 213 applies to anyone involved in the carrying on of the business and therefore directly qualifies the limitation of liability of members. Section 214 does not directly affect the liability of members as it is aimed specifically at Directors. In small companies, Directors are usually also the members of the company and so their limitation of liability is indirectly affected. Parent companies may also have their limited liability affected if they have acted as a shadow Director. (A shadow Director being anyone other than a professional advisor from whom the Directors of the company are accustomed to take instructions or directions – see Chapter 14.)

**Self-assessment**

1. Explain the difference between ss.213 and 214 of the Insolvency Act 1986.
2. Why was s.213 relatively unsuccessful?
3. What is s.214 designed to achieve?

**Summary**

The legislature has always been concerned to minimise the extent to which the *Salomon* principle could be used as an instrument of fraud. As a result it introduced the offence of fraudulent trading now contained in s.213 of the Insolvency Act 1986.

The requirement to prove ‘intent to defraud’ became too difficult in practice because of the possibility of a criminal offence arising and so the lesser offence of ‘wrongful trading’ was introduced in order to provide a remedy where Directors had behaved negligently rather than fraudulently. Thus if a Director continued to trade in circumstances where a reasonable Director would have stopped, the Director concerned will be liable to contribute to the company’s debts under s.214.
4.2 Judicial veil lifting

Veil lifting situations often present the judiciary with difficult choices as to where the loss should lie. As we observed with the Salomon, Lee and Macaura cases, the consequences of treating the company as a separate legal entity or not can be extreme. Over time the judiciary have swung from strictly applying the Salomon principle in these difficult situations to taking a more interventionist approach to try to achieve justice in a particular situation. The following cases should give some flavour of the types of situations that have arisen and the approach taken by the judiciary at the time.

In Gilford Motor Company Ltd v Horne [1933] Ch 935 a former employee who was bound by a covenant not to solicit customers from his former employers set up a company to do so. He argued that while he was bound by the covenant the company was not. The court found that the company was merely a front for Mr Horne and issued an injunction against him.

In Jones v Lipman [1962] 1 WLR 832 Mr Lipman had entered into a contract with Mr Jones for the sale of land. Mr Lipman then changed his mind and did not want to complete the sale. He formed a company in order to avoid the transaction and conveyed the land to it instead. He then claimed he no longer owned the land and could not comply with the contract. The judge found the company was but a façade or front for Mr Lipman and granted an order for specific performance.

By the 1960s the increasingly sophisticated use of group structures was beginning to cause the courts some difficulty with the strict application of the Salomon principle. Take, for example, a situation where Z Ltd (the parent or holding company) owns all the issued share capital in three other companies – A Ltd, B Ltd and C Ltd. These companies are known as wholly owned subsidiaries (see CA 1985, s.736). Z Ltd controls all three subsidiaries. In economic reality there is just one business but it is organised through four separate legal personalities. In effect this structure allows the advantages of limited liability to be availed of by the legal personality of the parent company. As a result the parent could choose to conduct its more risky or liability prone activities through A Ltd. The strict application of the Salomon principle would mean that if things go wrong the assets of Z Ltd as a shareholder of A Ltd with limited liability in theory cannot be touched.

In DHN Ltd. v Tower Hamlets [1976] 1 WLR 852 Lord Denning argued that a group of companies was in reality a single economic entity and should be treated as one. Two years later the House of Lords in Woolfson v Strathclyde R.C [1978] SLT 159 specifically disapproved of Denning’s views on group structures in finding that the veil of incorporation would be upheld unless it was a façade. The case of Adams v Cape Industries Plc [1990] 2 WLR 657 represents a significant move by the senior judiciary towards introducing more certainty into the interpretation of Salomon issues.
4.2.1 **Adams v Cape Industries Plc (1990)**

Adams is a complex case but broadly the following occurred. Until 1979, Cape, an English company, mined and marketed asbestos. Its worldwide marketing subsidiary was another English company, named Capasco. It also had a US marketing subsidiary incorporated in Illinois, named NAAC. In 1974, some 462 people sued Cape, Capasco, NAAC and others in Texas, for personal injuries arising from the installation of asbestos in a factory. Cape protested at the time that the Texas court had no jurisdiction over it but in the end it settled the action. In 1978, NAAC was closed down by Cape and other subsidiaries were formed with the express purpose of reorganising the business in the US to minimise Cape’s presence there, in respect of taxation and other liabilities. Between 1978 and 1979, a further 206 similar actions were commenced and default judgments were entered against Cape and Capasco (who again denied they were subject to the jurisdiction of the court but this time did not settle). In 1979 Cape sold its asbestos mining and marketing business and therefore had no assets in the US. Adams sought the enforcement of the US default judgment in England. The key issue was whether Cape was present within the US jurisdiction through its subsidiaries or had somehow submitted to the US jurisdiction. According to the Court of Appeal that could only be the case if it lifted the veil of incorporation, either treating the Cape group as one single entity, or finding the subsidiaries were a mere façade or that they were agents for Cape.

The court found that in cases where the courts had in the past treated a group as a ‘single economic unit’, thus disregarding the legal separateness of each company in the group, the court was involved in **interpreting a statute or document** (see below). This exception to maintaining corporate personality is qualified by the fact that there has to first be some lack of clarity about a statute or document which would allow the court to treat a group as a single entity. The court concluded that:

> save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of *Salomon v A. Salomon & Co Ltd* [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.

The Court of Appeal recognised the ‘mere façade concealing the true facts’ as being a well-established exception to the *Salomon* principle. The case of *Jones v Lipman* (1962) above is the classic example. There Mr Lipman’s sole motive in creating the company was to avoid the transaction. In determining whether the company is a mere façade the motives of those behind the alleged façade may be relevant. The Court of Appeal looked at the motives of Cape in structuring its US business through its various subsidiaries. It found that although Cape’s motive was to try to minimise its presence in the US for tax and other liabilities (and that that might make the company **morally** culpable) there was nothing **legally** wrong with this.
The court then finally considered the ‘agency’ argument. This was a straightforward application of agency principle. If the subsidiary was Cape's agent and acting within its actual or apparent authority, then the actions of the subsidiary would bind the parent. The court found that the subsidiaries were independent businesses free from the day-to-day control of Cape and with no general power to bind the parent. Therefore Cape could not be present in the US through its subsidiary agent.

*Adams* therefore narrows the situations where the veil of incorporation is in effect lifted to three situations:

- where the court is interpreting a statute or document (thus once fairness is rejected as the basis of intervention only a lack of clarity in the statute or document will allow intervention)
- where the company is a mere façade
- where the subsidiary is an agent of the company.

While there have been some notable departures from the Court of Appeal’s view in *Adams* (see *Creasey v Breachwood Motors Ltd* [1992] BCC 638 overruled by *Ord v Belhaven Pubs Ltd* [1998] 2 BCLC 447), the Court of Appeal’s interpretation in *Adams* of when veil lifting can occur has dominated judicial thinking since (see for example *Trustor AB v Smallbone* [2002] BCC 795.

**Activity 4.1**

Read Dignam and Lowry, paras 3.10–3.32 then write a short answer considering the following statement:

‘The Court of Appeal’s decision in *Adams* takes an overly cautious approach to veil lifting which does little to serve the interests of justice.’

*Feedback: see page 42.*

### 4.3 Veil lifting and tort

A finding of tortious liability against a shareholder (usually he is also a Director) for activities carried out through the medium of a company has the possibility of negating the *Salomon* principle. The courts have increasingly been faced with this possibility. The leading case on the issue is *Williams v Natural Life Health Foods Ltd* [1998] 2 All ER 577. There the House of Lords emphasised the *Salomon* principle in the context of a negligent misstatement claim. The Managing Director of Natural Life Health Foods Ltd (NLHF) was also its majority shareholder. The company’s business was selling franchises to run retail health food shops. One such franchise had been sold to the claimant on the basis of a brochure which included detailed financial projections. The managing director had provided much of the information for the brochure. The claimant had not dealt with the Managing Director but only with an employee of NLHF. The claimant entered into a franchise agreement with NLHF but the franchised shop ceased trading after losing a substantial amount of money. He subsequently brought an action against NHLF for losses suffered as a result of its negligent information contained in the brochure. NLHF subsequently ceased to trade and was dissolved. The claimant then continued the action against the Managing Director and majority shareholder alone,
alleging he had assumed a personal responsibility towards the claimant.

The House of Lords seemed particularly aware that the effect of this claim was to try to nullify the protection offered by limited liability. In its judgment the House of Lords considered that a Director or employee of a company could only be personally liable for negligent misstatement if there was reasonable reliance by the claimant on an assumption of personal responsibility by the Director so as to create a special relationship between them. There was no evidence in the present case that there had been any personal dealings which could have conveyed to the claimant that the Managing Director was prepared to assume personal liability for the franchise agreement (see also Noel v Poland [2002] Lloyd’s Rep. IR 30).

Other recent cases suggest that if the tort is deceit rather than negligence the courts will more readily allow personal liability to flow to a Director or employee. (See Daido Asia Japan Co Ltd v Rothen [2002] BCC 589 and Standard Chartered Bank v Pakistan National Shipping Corp (No.2) [2003] 1 AC 959.)

However directors’ liability in tort has proved to be less than settled. In MCA Records Inc v Charly Records Ltd (No 5) [2003] 1 BCLC 93 a director had authorised a number of infringing acts under the Copyright Designs and Patent Act 1988. The Court of Appeal in a very detailed consideration of the issue of directors’ liability in tort, including the Williams case, took a more relaxed approach to the possibility of liability. The court concluded:

> there is no reason why a person who happens to be a director or controlling shareholder of a company should not be liable with the company as a joint tortfeasor if he is not exercising control through the constitutional organs of the company and the circumstances are such that he would be so liable if he were not a director or controlling shareholder.

The court then went on to find the director liable as a joint tortfeasor. (See also Koninklijke Philips Electronics NV v Princo Digital Disc GmbH [2004] 2 BCLC 50, where a company director was also held personally liable.)

### Activity 4.2

Read Dignam and Lowry, paras 3.33–3.51 and consider whether involuntary creditors are adequately protected by the Adams decision.

*Feedback: see page 42.*

### Summary

It is important that you get a solid understanding of the issues facing the judiciary in this area. In essence the judiciary are being asked to decide who loses out when a business ends. In normal commercial situations this will be as the Companies Act intends – therefore the burden falls on the creditors. However if there is a suggestion that the company has been used for fraud or fraud-like behaviour (e.g. Jones v Lipman) the courts may lift the veil. At various times however the Salomon principle was only a starting
point and the courts would lift the veil in a number of situations if the interests of justice required them to do so. This led to great uncertainty which has been redressed by the restrictive case of *Adams*.

**Useful further reading**

Ottolenghi, S. [1990] ‘From peeping behind the corporate veil to ignoring it completely’, *MLR* 338.


**Reminder of learning outcomes**

By this stage you should be able to:

- describe the situations where legislation will allow the veil of incorporation to be lifted
- explain the main categories of veil lifting applied by the courts.

**Sample examination questions**

**Question 1** John and Amanda are brother and sister and have been running the family business Rix Ltd for ten years. They both sit on the Board of Directors of Rix Ltd and each holds 30 per cent of the shares in the company. The remaining shares are held equally by their father, Jim, and uncle, Tom. Jim and Tom used to run the company but have retired now. They still have seats on the Board of Directors. For the first five years after the retirement of Jim and Tom the company made an annual profit of approximately £100,000. After that the profits declined for three years and in the last two years the company has made losses of £50,000 and £100,000. John and Amanda have grave concerns about the future of the business but at a Board meeting to discuss ceasing trading Jim and Tom insist that things will get better. The Board resolves to continue trading.

Consider the implications for the Board members of this decision.

**Question 2** Dick and his wife Bunny are owed £25,000 by Bio Ltd. Bio Ltd has refused to pay the money owed and Dick and Bunny have initiated a court action to recover the moneys owed to them. Bounce Ltd is the parent company of Bio Ltd and has recently been advised by its accountant that it could reduce its tax liability for the year 1998/1999 by removing all the assets from Bio Ltd and closing it down. Bounce Ltd has decided to follow that advice.

Discuss the implications of this decision for Dick and Bunny.
**Advice on answering these questions**

**Question 1 (a)** It appears that there is no suggestion of fraud here; rather it fits more with the case law on the application of s.214.

**(b)** Apply s.214 to the facts of this question.

**(c)** Does the Board meeting represent the necessary ‘point of no return’?

**(d)** Consider the possible voting at the meeting. If it was unanimous, there is no problem and the wrongful trading provisions apply to them all. However, Boards vote by simple majority and so the possibility remains that one of the Directors could have dissented. What would be that Director’s position under s.214 if he or she wished to cease trading but the rest of the Board voted to continue? If that Director continues to carry out their role after the vote is he or she equally liable under s.214?

**Question 2 (a)** This is a relatively straightforward question similar on its facts to the *Ord* and *Creasey* cases.

**(b)** *Ord* follows *Adams* strictly and finds that a group reorganisation to minimise financial liability is allowable and will not engage a veil lifting exercise.

**(c)** *Creasey* is a rogue case but it is worth applying here as an alternative in which case Dick and Bunny might be able to recover from the parent company.
Feedback to activities: Chapter 4

Activity 4.1 You will have noted from your reading that from the 1960s until the 1990s there was little consistency in the way the senior judiciary approached difficult cases where veil lifting was an option. In 1985 the Court of Appeal in Re a Company [1985] BCLC 37, Ch.D could draw on cases such as Wallersteiner v Moir [1974] 1 WLR 991 to argue that the court can use its power to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal efficacy of the corporate structure under consideration. Equally four years later the Court of Appeal in National Dock Labour Board v Pinn & Wheeler Ltd [1989] BCLC 647 could draw on cases such as Woolfson v Strathclyde RC [1978] SLT 159 to argue for a strict interpretation of the Salomon principle. In short there was little consistency or certainty in a very important area of company law.

This, it seems, is what the Court of Appeal in Adams seeks to address by narrowing the categories of veil lifting and eliminating any concept of veil lifting in the interests of justice. Instead narrow categories have been created which are somewhat elusive. It does indeed seem an overly cautious approach which does little to serve the interests of justice.

Activity 4.2 Involuntary creditors (generally in this context the victims of personal injury by the company) are in a vulnerable position when it comes to the application of the Salomon principle. Normal creditors have at least a way of calculating the business risk and charging more or monitoring in order to protect themselves. Involuntary creditors cannot do so, and so if, for example, a parent company remains protected from the tortious activities of its subsidiary by the Salomon principle, involuntary creditors can suffer badly.

Thankfully the courts seem to realise this and draw a subtle distinction between commercial torts (negligent misstatement) where Salomon is strictly applied and personal injury actions where a more flexible approach is taken (see Lubbe and Others v Cape Industries Plc [2000] 1 WLR 1545).