## Chapter 3 The nature of legal personality

### Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Corporate personality</td>
<td>29</td>
</tr>
<tr>
<td>3.2</td>
<td>Salomon v Salomon &amp; Co</td>
<td>30</td>
</tr>
<tr>
<td>3.3</td>
<td>Other cases illustrating the Salomon principle</td>
<td>31</td>
</tr>
<tr>
<td>3.4</td>
<td>Limited liability</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>Reflect and review</td>
<td>33</td>
</tr>
</tbody>
</table>
Introduction

In this chapter we explore the related concepts of corporate legal personality and limited liability. These concepts are central to 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’.

Cases

- Salomon v Salomon & Co [1897] AC 22
- Macaura v Northern Assurance Co [1925] AC 619
- Lee v Lee’s Air Farming [1961] AC 12
- Barings plc (In Liquidation) v Coopers & Lybrand (No 4) [2002] 2 BCLC 364
- Giles v Rhind [2003] 2 WLR 237
3.1 Corporate personality

Corporate personality refers to the fact that, as far as the law is concerned, a company really exists. This means that 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 allows limited liability for shareholders 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, 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 were 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?
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 Ltd, 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

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.

Re-read Dignam and Lowry, Chapter 2, paras 2.2–2.12 and paras 2.32–2.44.
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 with children, for example), a company can have legal personality without limited liability if that is how it is conferred by the statute. A company may still be formed today without limited liability as a registered unlimited company (s.3(4) CA 2006).

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


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.
Reflect and review

Look through the points listed below.

Are you ready to move on to the next chapter?

Ready to move on = I am satisfied that I have sufficient understanding of the principles outlined in this chapter to enable me to go on to the next chapter.

Need to revise first = There are one or two areas I am unsure about and need to revise before I go on to the next chapter.

Need to study again = I found many or all of the principles outlined in this chapter very difficult and need to go over them again before I move on.

<table>
<thead>
<tr>
<th>Points</th>
<th>Ready to move on</th>
<th>Need to revise first</th>
<th>Need to study again</th>
</tr>
</thead>
<tbody>
<tr>
<td>I can explain what is meant by 'corporate legal personality'.</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>I can illustrate the key effects of corporate legal personality in relation to liability.</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>

If you ticked ‘need to revise first’, which sections of the chapter are you going to revise?

<table>
<thead>
<tr>
<th>Sections</th>
<th>Must revise</th>
<th>Revision done</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Corporate personality</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>3.2 Salomon v Salomon &amp; Co</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>3.3 Other cases illustrating the Salomon principle</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>3.4 Limited liability</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>