COMPANIES AS SEPARATE LEGAL "PERSONS"

Introduction

People sometimes mistake the directors or shareholders of a company for the company itself. Such a mistake will have legal consequences when a dispute arises. Those consequences may well include and order that a plaintiff pay the costs of the director or shareholder where the proper defendant is a company. It is important to understand whether any agreement or other activity involves a company or a person or some other type of organisation (such as a private members' club or a limited partnership).

The general rule in relation to companies is that a company is an artificial person, separate and distinct from its directors and shareholders, and neither the directors nor shareholders are personally liable for the defaults of the company (save is special narrowly defined circumstances, which form specific exceptions to the general rule). That general rule dates back more than a century and was clearly set out in the English case of *Salomon v. Salomon & Co. Ltd.*[1]

Overview

Salomon v. Salomon & Co. Ltd. is a seminal decision of the House of Lords on the standing of a company[2] as a matter of law following the enactment of the *Companies Act 1862*. Subsequent Companies Acts in Bermuda and the United Kingdom have assumed the validity of the decision in *Salomon v. Salomon & Co. Ltd.* and have done nothing to dilute that decision. The effect of the decision in *Salomon v. Salomon & Co. Ltd.* was to uphold the concept of a company as an independent legal entity, or an artificial "person", separate and distinct from its members (shareholders) and its directors.

Background

Aron Salomon was a leather merchant and wholesale boot-maker who for many years ran his business as a sole proprietor. By 1892, his sons had become interested in taking part in the business in consequence of which Aron Salomon decided to incorporate his business as a company, Salomon & Co. Ltd. (the "Company"), with a view to transferring his leather and boot-making business to the Company. The members (shareholders) of the Company were to be Aron Salomon and his family. Aron Salomon entered into a preliminary agreement with one Adolph Anhalt, as trustee for the (future) Company, settling the terms upon which the transfer of the business was to be made. One of the conditions was that, in part payment, Aron Salomon was to receive £10,000 in debentures

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1 [1897] A.C. 22; [1895-1899] All ER Rep. 33.

2 For present purposes the terms "company" and "corporation" are interchangeable.

evidencing a loan to the Company in that amount. A memorandum of association (a necessary document to form a company) was then executed by Aron Salomon, his wife, daughter, and four sons in which the leading object for which the Company was formed was said to be the adoption and carrying into effect of the provisional agreement entered into with Adolph Anhalt. The memorandum of association was registered on July 28, 1892, and the effect of registration was to incorporate the Company with liability limited by shares.

At the time, the legal requirement for incorporation was that at least seven persons subscribe as members of a company (*i.e.* as shareholders). As mentioned above, the members were Aron Salomon, his wife, daughter and four sons. Two of his sons became directors and Aron Salomon was managing director.

Aron Salomon sold his business to the Company for almost £39,000, of which £10,000 was a debt to him evidenced by the debentures. Aron Salomon thus became the Company's principal shareholder and its principal creditor.

When the Company went into liquidation the following year (1893), the liquidator argued that the debentures used by Aron Salomon as security for the debt were invalid on the ground of fraud. The judge at first instance accepted that argument, ruling that since Aron Salomon had created the Company solely for the purpose of transferring his business to it, the Company was in reality his agent and he, as principal, was liable for the Company's debts to unsecured creditors.

Aron Salomon appealed that decision to the Court of Appeal,[3] which also ruled against him, though on the ground that Aron Salomon had abused the process of incorporation and limited liability, which the Legislature had intended only to confer on 'independent *bona fide* shareholders, who had a mind and will of their own and were not mere puppets.' The Lord Justices of Appeal variously described the Company as a myth and a fiction and said that the incorporation of the business by Aron Salomon had been a mere scheme to enable him to carry on as before but with limited liability.

The House of Lords unanimously overturned the decisions of the courts below, rejecting the arguments in relation to both agency and fraud. Lord Halsbury, the Lord High Chancellor of Great Britain, rested his opinion on the basis that there was nothing in the *Companies Act 1862* about whether the subscribers (*i.e.* the shareholders) should be independent of the majority shareholder. The Company was duly constituted in law and it was not the function of judges to read into the statute limitations they themselves considered expedient. The

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[3] Reported at [1895] 2 Ch. 323.

Companies Act 1862 created limited liability companies as legal persons, separate and distinct from the members or directors and it. Lord Halsbury also noted that the statute 'enacts nothing as to the extent or degree of interest which may be held by each of the seven [members] or as to the proportion of interest or influence possessed by one or the majority over the others.'

Lord Herschell noted the potentially "far reaching" implications of the Court of Appeal's logic and that in recent years many companies had been set up in which one or more of the seven shareholders were "disinterested persons" who did not wield any influence over the management of the company. Anyone dealing with such a company was aware of its nature as such, and could by consulting the register of members become aware of the breakdown of ownership amongst the members.

Lord Macnaghten questioned why it was said to be wrong of Mr. Salomon in taking advantage of the provisions set out in the statute, as he was perfectly and legitimately entitled to do. It was not the function of judges to read limitations into a statute on the basis of their own personal view that, if the laws of the land allowed such a thing, they were "in a most lamentable state", as Sir Richard Malins V-C had stated in an earlier case, *Re Baglan Hall Colliery Co.*,[4] which had likewise been overturned by the House of Lords.

Subsequent developments

In more than a century since *Salomon v. Salomon & Co. Ltd.* was decided, various exceptional circumstances have been identified, both by legislatures and the judiciary in England and elsewhere, including Bermuda, as to when courts can legitimately disregard a company's distinct legal personality and "pierce the corporate veil", such as where a fraud has been committed.

But the basic premise of the judgment in *Salomon v. Salomon & Co. Ltd.* remains unaltered today: a limited liability company is a legal person, separate and distinct from the members or directors and it.

This article addresses general principles only and is not intended to be a comprehensive exposition of the subject. Specific legal advice should be obtained in respect of any particular issue in Bermuda regarding the liability of a company.

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[4] (1870) 5 Ch. App. 346; 39 L.J. Ch. 591.