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Chapter 1

Starting a company

Key terms

- **Alter ego** – a device that attributes the acts of important managers to the company itself, so that the company may be sued for compensation or convicted of crimes.
- **Community interest company (CIC)** – this type of company was created by the Companies (Audit, Investigations and Community Enterprise) Act 2004. It is a form of company designed for community enterprises that are not charities.
- **Corporate personality** – the legal fiction that the company is an entity separate from the people actually involved in it.
- **Lifting the veil** – looking at the facts and disregarding the effect of the legal fiction that all companies are completely separate from their shareholders.
- **Private company (Ltd)** – this type of company may not advertise to the public in order to sell shares.
- **Public company (PLC)** – this type of company may offer shares to the public by advertisement.

1.1 Starting a company

The first decision that must be made by those considering incorporation of a business is the type of company that will be suitable.

1.1.1 Unlimited and limited companies

1.1.1(a) Unlimited companies

An unlimited company has the advantage of being a legal entity separate from its members but lacks the advantage that most people seek from incorporation, that is, the limited liability of the members. Thus, the members of an unlimited liability company will be held responsible for all of the debts of the company without limit. Unlimited companies therefore form only a small proportion of the total number of registered companies.

1.1.1(b) Limited liability companies

'The limited liability corporation is the greatest single discovery of modern times. Even steam and electricity are less important than the limited liability company,' said Professor NM Butler, President of Columbia University (quoted by AL Diamond in Orhnial (ed.), *Limited Liability and the Corporation* (Law Society of Canada, 1982) at 42; see also Sealy, *Company Law and Commercial Reality* (Sweet & Maxwell, 1984) at 1).

Why is the limited liability company so important? A huge proportion of the world's wealth is generated by companies, and a company is most often used by people as a tool for running a commercial enterprise. Many of these businesses start in a small way, often by cooperation between a small number of people. If

such a commercial undertaking prospers, the persons involved will wish to expand the undertaking, which will generally require an injection of money. This may be achieved by inviting more people to contribute to the capital sum that the business uses to fund its activities. The alternative is to raise a loan. The latter course has the disadvantage of being expensive, because the lender will charge interest. On the other hand, the option of inviting a large number of persons to be involved in a business may have considerable disadvantages. One is that they may disagree with each other as to how the business should best be run. They may even disagree with each other as to who should make the decisions about how the business is to be run. This is partially solved in a company by the necessity of having a formal constitution (the memorandum and articles of association – see Section 1.2.2), which sets out the voting and other rights of all the members (shareholders) of a company.

Another disadvantage of expansion of a business is that as the amounts dealt with increase, so too do the risks. The great advantage of the most widely used type of company is that its members enjoy 'limited liability'. This means that if the company becomes unable to pay its debts, the members of that company will not have to contribute towards paying all the company's debts out of their own private funds: they are liable to pay only the amount they have paid, or have promised to pay, for their shares. This means that contributors to the funds of businesses that are run on this limited liability basis may be easier to find. Limited liability is also said to encourage greater boldness and risk-taking within the business community, so that new avenues to increasing commerce are explored.

The advantage of limited liability may lead quite small businesses to use a company, although this may not be advantageous from a tax point of view and leads to a number of obligations to file accounts and so on, which create a considerable burden for a small concern. Furthermore, if a very small business wishes to raise a loan from a bank, the bank will normally require a personal guarantee from the people running the business. This means that the advantage of limited liability will, practically speaking, be lost.

1.1.1(c) Corporate personality

A further disadvantage of attempting to run a business with a large number of people involved is that considerable difficulties may be experienced when some of those people die, wish to retire or simply leave the business. There may be great difficulties for a person dealing with the business in deciding precisely who is liable to pay him. In a shifting body of debtors, an outsider may experience extreme difficulty in determining which people were actually involved in the business at the time that is relevant to his claim against it. This difficulty is solved by the legal fiction of corporate personality. The idea is that the company is an entity separate from the people actually involved in running it. This fictional 'legal person' owns the property of the business, owes the money that is due to business creditors and is unchanging even though the people involved in the business come and go. Corporate personality is discussed in further detail in Section 1.5.

The UK company law rules were the subject of a Department of Trade and Industry review during 2001–02. Although it was publicised as a 'fundamental review' of company law, the changes that resulted were quite modest in substance. However, the Companies Act 2006 almost completely replaces the previous Companies Act 1985, so that many sections have been slightly changed in substance and bear a different number in the new Act. This is important, because some of the case law will refer to the previous Companies Act 1985 and readers will have to find the relevant section in the Companies Act 2006.

As we examine company law of the UK, it is useful to consider the purpose behind the various rules and whether they are sufficiently effective in achieving their purpose and also whether they justify the expense that is incurred by companies to ensure that their operations stay within the complicated framework that has grown up.

1.1.2 Public and private companies

The fundamental difference between public and private companies is that only public companies may invite the public to subscribe for shares. Section 755 of the Companies Act 2006 prohibits a private company from offering, allotting or agreeing to allot securities to the public or acting with a view to their being offered to the public. Section 756 defines 'offer to the public' as including an offer to any section of the public, however selected. However, it is not an offer to the public if it can properly be regarded, in all the circumstances, as:

1. not being calculated to result, directly or indirectly, in securities of the company becoming available to persons other than those receiving the offer; or
2. otherwise being a private concern of the person receiving it and the person making it.

In other words, the offeror and offeree must either be known to each other or be part of a close network of friends, family or acquaintances for the offer not to constitute an 'offer to the public'.

Public companies are therefore more suitable for inviting investment by large numbers of people. A private company is particularly suitable for running a business in which a small number of people are involved. Professor Len Sealy describes the situation as follows:

> During the nineteenth century (and indeed for a considerable period before that) the formation of almost all companies was followed immediately by an appeal to the public to participate in the new venture by joining as members and subscribing for 'shares' in the 'joint stock' … The main reason for 'going public' in this way was to raise funds in the large amounts necessary for the enterprises of the period – often massive operations which built a large proportion of the world's railways, laid submarine cables, opened up trade to distant parts and provided the banking, insurance and other services to support such activities. The promoters would publish a 'prospectus', giving information about the undertaking and inviting subscriptions. This process is often referred to as a 'flotation' of the company or, more accurately, of its securities.
>
> (Sealy, *Cases and Materials in Company Law*, 6th edn, Butterworths, 1996)

As one might expect, the regulations governing public companies are more extensive than those governing private companies. In many areas, however, no distinction is made between the two types of company.

1.1.3 Off-the-shelf companies

Ready-made companies may be acquired from enterprises that register a number of companies and hold them dormant until they are purchased by a customer. This may save time when a company is needed quickly for a particular enterprise. There used to be a potential problem in that the objects clause of such a company might not precisely cover the enterprise in question, with the result that such a company would be precluded from carrying on the desired business. Contracts made in pursuance of such an enterprise would be of no effect (see Chapter 4). However, many such companies will be formed in the future with the objects of a general commercial company and with unlimited powers on the basis of section 31 of the Companies Act 2006.

1.1.4 Community interest companies

Community Interest Companies (CICs) are limited companies with special additional features, created for the use of people who want to conduct a business or other activity for the benefit of a community and not purely for private advantage. They were introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004. The fundamental idea was that this would provide a legal form for those considering creating a social enterprise. This is achieved by a 'community interest test' and an 'asset lock', which ensures that the CIC is established for community purposes and that the assets and profits are dedicated to these purposes. Registration of a company as a CIC has to be approved by the Regulator, who also has a continuing monitoring and enforcement role.

Setting up a CIC is a big step because, once registered, the only ways of changing its form are:

1. dissolving the company so that it ceases to exist altogether or
2. converting the CIC to a charity and subjecting the company to the more onerous regulatory regime of charity law.

This means that once a company is a CIC, it cannot become an ordinary company.

The Department for Business, Innovation and Skills regulates CICs. The basic idea is to have a limited liability company but for a special reason for the community. CICs should have a flexible structure, including limited liability, the ability to tailor the management of the company and at some time provide a real benefit for the community. CICs are not focused on profit, and if the company is dissolved, the assets of the company should go to the community. Charity status for CICs is not appropriate because of the rigid structures of charity legislation. CICs can be

funded by individuals, shareholders or foundations, and some types of CICs can make profits and then pay dividends. However, there are restrictions on dividends and assets, and the CIC Regulator can change the caps on dividends and assets.

The office of the Regulator of Community Interests Companies published its Operational Report 2011–2012, saying that CICs are now part of the social enterprise landscape: 'We have CICs in every sector including the arts, education, environment, health, industry and transport.' On 10 December 2013, there were more than 8,000 CICs.

1.2 Formation of a company

Section 7 of the Companies Act 2006 describes the method for forming a company:

A company is formed under this Act by one or more persons—

(a) subscribing their names to a memorandum of association …, and
(b) complying with the requirements of this Act as to registration …

If only it were that simple! That, of course, describes only the basic requirements for forming a company. Many and greater complications will arise when we look at how the company makes decisions and does business in the course of its active life.

1.2.1 Financing a company

The first issue for a business is the way in which the business is to be financed. Limited liability companies have the advantage that the members' liability to contribute to the debts of the company has a fixed limit that is always clear. Traditionally, there were two ways of setting the limit: (i) by issuing shares or (ii) by taking guarantees from the members that they would contribute up to a fixed amount to the debts of the company when it was wound up or when it needed money in particular circumstances. The first type of company is a company limited by shares, the second is a company limited by guarantee. No new companies limited by guarantee and having a share capital to provide working money may be formed (Companies Act 2006, s 5). This means that a guarantee company formed in the future cannot have any contributions from guarantees. This form is therefore unsuitable for commercial enterprises, although the form has been extensively used to carry out semi-official functions, particularly in the sphere of regulation of the financial services market.

In a company limited by shares, the members know that they will never have to pay more into the company than the full purchase price of their shares. This need not necessarily be paid when they are first purchased. When some money is outstanding on shares, the company may issue a 'call' for the remainder to be paid, but it can never demand more than the full price due to the company for a particular share. Such a company will be registered as a 'company limited by shares'. By

section 3(2) of the Companies Act 2006, if the liability of shareholders is limited to the amount, if any, unpaid on the shares held by them, the company is 'limited by shares'. By section 3(3), if the liability is limited to such amount 'as the members undertake to contribute to the assets of the company in the event of its being wound up', it is a 'company limited by guarantee'.

1.2.1(a) Minimum capital requirements for a public company

A private company need have only a very small amount of capital. However, the European Community Second Directive set a minimum amount of capital for a public company. Section 763 of the Companies Act 2006 sets the minimum for UK companies at £50,000 or the euro equivalent and gives power to the Secretary of State to specify a different sum by statutory instrument. The company is not obliged to have received the full £50,000. However, by section 586, public companies must receive at least one-quarter of the nominal value of the shares. The amount of capital actually contributed could be as little as £12,500, although the company would have a right to make a 'call' on the shareholders demanding payment of the unpaid capital (that is, the outstanding £37,500).

By section 761 of the 2006 Act, it is a criminal offence committed by the public company, and any officer of it in default, to do business or to borrow money before the Registrar of Companies has issued a trading certificate to the effect that he is satisfied that the nominal value of the company's allotted share capital is not less than the prescribed minimum and that he has received a statutory declaration, which must be signed by a director or secretary of the company and must:

1. state that the nominal value of the company's allotted share capital is not less than the authorised minimum;
2. specify the amount, or estimated amount, of the company's preliminary expenses;
3. specify any amount or benefit paid or given, or intended to be paid or given, to any promoter of the company, and the consideration for the payment or benefit (see Chapter 4).

1.2.2 Registration of a company

1.2.2(a) The memorandum of association and the company constitution

It is essential that a company have a memorandum of association, which under section 8 of the Act is:

a memorandum stating that the subscribers—

(a) wish to form a company under this Act, and
(b) agree to become members of the company and, in the case of a company that is to have a share capital, to take at least one share each.

However, the constitution of the company comprises the company's articles of association and any resolutions made under Chapter 3 of the Act, which essentially

are 'important' resolutions passed by special majorities or by unanimous agreement. It is important to note that a company must have articles of association, but if none is drafted or not all of the provisions of the 'model articles' are excluded, then those model articles apply by default. The model articles are the default company constitution for limited companies in the UK. Section 20 of Companies Act 2006 clarifies that they form part of the company's articles in the same manner and to the same extent as if articles in the form of those articles had been duly registered (for further detail on the articles of association, see Chapter 3).

The memorandum must be delivered to the Registrar of Companies together with an application for registration. Section 9 sets out the basic requirements that must be included in the application for registration. These are:

- the name of the company;
- whether the registered office is to be in England and Wales, in Wales, in Scotland or Northern Ireland;
- whether liability of the members of the company is to be limited and, if so, whether it is to be limited by shares or guarantee;
- whether it is to be a private or a public limited company.

The application must also contain a statement of proposed officers of the company (s 9(4)(c)).

1.2.2(b) Name

The choice of a name for a company is of considerable importance and subject to a number of restrictions. With exceptions for companies of a charitable or 'social' nature, if the liability of members of the company is to be limited, the company name must end with 'Limited' (permitted abbreviation 'Ltd') if a private company and with 'Public Limited Company' (permitted abbreviation 'PLC' or 'plc') if a public company (or the Welsh equivalents – see further Section 1.2.2(d)).

By section 53 of the Companies Act 2006, a company may not be registered with a name which, in the opinion of the Secretary of State, would constitute a criminal offence or be offensive, and the Secretary of State's approval is required for the use of a name which would be likely to give the impression that the company is connected with the government or any local authority or which includes any word or expression specified in regulations made by the Secretary of State (Companies Act 2006, ss 54 and 55). The name must not be the same as any other kept in the index of company names held by the Registrar (Companies Act 2006, s 66).

By sections 77 to 81 of the Act, a company may change its name by special resolution, by any other means provided for by its articles and by a resolution of its directors.

One further restriction on the selection of names is imposed by the rules against using a name so similar to the name used by an existing business as to be likely to mislead the public into confusing the two concerns (so-called passing off). Thus, in *Exxon Corporation v Exxon Insurance Consultants International Ltd* [1982] Ch 119, the court granted an injunction restraining the defendants from using the word 'Exxon' in their company's name.

In *Reckitt & Colman Ltd v Borden Inc* [1990] 1 All ER 873, Lord Oliver reaffirmed the test for passing off. The claimant in a passing-off action has to:

> establish a goodwill or reputation attached to the goods or services which he supplies in the mind of the purchasing public by association with the identifying 'get-up' (whether it consists simply of a brand name or a trade description, or the individual features of labelling or packaging) under which his particular goods or services are offered to the public, such that the get-up is recognised by the public as distinctive specifically of the [claimant's] goods or services. Second, he must demonstrate a misrepresentation by the defendant to the public (whether or not intentional) leading or likely to lead the public to believe that goods or services offered by him are the goods or services of the [claimant]. … Third, he must demonstrate that he suffers or … that he is likely to suffer damage by reason of the erroneous belief engendered by the defendant's misrepresentation that the source of the defendant's goods or services is the same as the source of those offered by the [claimant].

Therefore, the three basic elements of passing off are reputation, misrepresentation and damage to goodwill.

In *Asprey & Garrard Ltd v WRA (Guns) Ltd & Anor* [2001] EWCA Civ 1499, the issue was the defence arising from the use of one's own name in business. Although Mr Asprey was using his own name, that name could be associated with a different retail shop (a famous jeweller), causing confusion. The Court of Appeal stated that in this case the use of the name caused not only confusion but also deception, as the name had been used as a trade mark. Thus, it is evident that a person cannot carry on business in his own name if he is not honest and he causes deception. The principle is that a person's using his own name in business cannot prevent a passing-off claim by a company already operating under the same or a very similar name.

1.2.2(c) Share capital

By section 9(4) of the Companies Act 2006, in the case of a company limited by share capital, the application must state the amount of share capital with which the company proposes to be registered (further details in Chapter 5). This is known as its 'authorised share capital', 'registered share capital' or 'nominal share capital'. It does not represent the amount actually contributed at the time when the company is formed, which may be only part of the share price.

1.2.2(d) Private or public limited company

As we have seen, where a company is to be registered as a public company, this must be stated in the application for registration and the words 'public limited company' (or the abbreviation 'PLC' or 'plc') must appear at the end of its name unless it is Welsh or a CIC (Companies Act 2006, s 58). A private limited company must normally have a name ending in 'Ltd' unless it is a CIC, a charity or otherwise exempted by sections 60, 61 or 62 of the Act.

1.2.3 Incorporation

Section 9 of the Companies Act 2006 requires delivery of the memorandum, the application for registration and a statement of compliance to the Registrar of Companies for England and Wales, if the registered office is to be situated in either England or Wales, and for Scotland if the registered office is to be situated in Scotland. The statement must be signed by or on behalf of the subscribers to the

memorandum, and the intended address of the company's registered office must be stated.

1.2.4 Duty of the Registrar

Section 14 of the Companies Act 2006 provides that if the Registrar is satisfied that the requirements of the Act have been complied with, he must register the documents delivered to him. Under section 15, he must issue a certificate that the company is incorporated. Section 15(4) provides that the certificate of incorporation is conclusive evidence that the requirements of the Act have been met and the company is duly registered. Thus, the company's existence as such is unchallengeable from the date of the issue of the certificate of incorporation.

By section 16 of the Act:

(1) The registration of a company has the following effects as from the date of incorporation.

(2) The subscribers to the memorandum, together with such other persons as may from time to time become members of the company, are a body corporate by the name stated in the certificate of incorporation.

(3) That body corporate is capable of exercising all the functions of an incorporated company.

(4) The status and registered office of the company are as stated in, or in connection with, the application for registration.

(5) In the case of a company having a share capital, the subscribers to the memorandum become holders of the shares specified in the statement of capital and initial shareholdings.

(6) The persons named in the statement of proposed officers—
    (a) as director, or
    (b) as secretary or joint secretary of the company,
    are deemed to have been appointed to that office.

1.3 Change of status from public to private company and vice versa

A change of status from private to public company is much more common than registration as a public company on initial incorporation. Part 7 of the Companies Act 2006 provides for this change of status from private to public and from public to private status. In both cases, the members of the company must pass a special resolution (a resolution passed by at least 75 per cent of the votes cast) to effect the change. In the case of a change from private to public, the Registrar of Companies must be provided with a statutory declaration that the minimum capital requirements for public companies have been satisfied (see Section 1.2.1(a)) and that the requisite special resolution has been passed (s 90).

If the reverse change of status from public to private is undertaken, the members may find that it is more difficult to sell their shares. There are safeguards in the Act aimed at protecting a minority who object to such a change of status. Under section 98 of the Companies Act 2006, the holders of 5 per cent or more of the nominal value of a public company's shares, any class of the company's issued share capital or 50 members may apply to the court for the cancellation of a special resolution to request re-registration as a private company. The court has an unfettered discretion to cancel or approve the resolution on such terms as it thinks fit (Companies Act 2006, s 98(4) and (5)).

1.4 Groups

The old definition of the parent–subsidiary relationship was to be found in section 736 of the Companies Act 1985. That read:

(1) For the purposes of this Act, a company is deemed to be a subsidiary of another if (but only if)—

   (a) that other either—

      (i) is a member of it and controls the composition of its board of directors, or
      (ii) holds more than half in nominal value of its equity share capital, or

   (b) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

This definition caused two main difficulties. The first was that it concentrated on the number of shares held (the total of all of the shares together is known as the equity share capital). This ignores the fact that control is exercised through voting rights, which need have no relationship to the number of shares held.

The second difficulty lay with the reference to the control of the board of directors (s 736(1)(a)(i)). Under the original sections in the 1985 Act, a company was deemed to control the composition of the board of directors if it could appoint or remove the holders of all or a majority of the directorships. If one company could appoint less than a majority of the directors, but those it was able to appoint had extra voting rights so that they could outvote the other directors, then control of the board's activities was effectively achieved, while the arrangement was still outside the scope of the section.

By these and other methods, it was possible to avoid the intended effect of the section, which was to treat a group of companies as a single business for various purposes, including accounting purposes. Because of this, the Companies Act 1989 introduced new definitions of this relationship. These now appear in the Companies Act 2006, section 1159:

(1) A company is a 'subsidiary' of another company, its 'holding company', if that other company—

(a) holds a majority of the voting rights in it, or
(b) is a member of it and has the right to appoint or remove a majority of its board of directors, or
(c) is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in it, or if it is a subsidiary of a company that is itself a subsidiary of that other company.

(2) A company is a 'wholly owned subsidiary' of another company if it has no members except that other and that other's wholly owned subsidiaries or persons acting on behalf of that other or its wholly owned subsidiaries.

The emphasis has shifted from ownership of shares to control of voting rights, which are further defined by the Act. This gives a more realistic picture of a group of companies. (Further details of company groups and multinational companies are to be found in Chapter 14.)

1.5 Corporate personality

1.5.1 Meaning of corporate personality

The essence of a company is that it has a legal personality distinct from the people who compose it. This means that even if the people running the company are continually changing, the company itself retains its identity, and the business need not be stopped and restarted with every change in the managers or members (shareholders) of the business. If the company is a limited liability company, not only is the money owned by the company regarded as wholly distinct from the money owned by those running the company but also the members of the company are not liable for the debts of the company (except where the law has made exceptions to this rule in order to prevent fraudulent or unfair practices by those in charge). Members may be called upon to pay only the full price of their shares. After that, a creditor must depend on the company's money to satisfy his claim.

This limitation of the liability of the members has led to careful rules being drawn up to attempt to prevent a company from wasting its money (Chapter 7). It is one of the disadvantages of incorporation that a number of formal rules, designed to protect people doing business with companies, have to be complied with. A partnership that consists of people carrying on a business with a view to making profits needs comply with many fewer formalities. On the other hand, the members of an ordinary partnership are liable for all the debts incurred by the business they run. (It is possible now to form a limited liability partnership.) If large losses are made, partners in an ordinary partnership must contribute their own money to clear the debts of the business. In practice, this may be a distinction without a difference since, where small businesses are concerned, banks will not lend money to a company without first securing guarantees from those running the business, so that if the company cannot pay its debts, such debts will be met from the personal assets of those in charge.

The separate personality of a company creates a range of problems, because although the company is regarded as a person in law, it can function only through the humans who are running the business in which the company is involved.

The law must regulate the relationships between a company and its creators and members or shareholders, as well as the relationship between a company and 'outsiders' who do business with the company.

1.5.2 The legal basis for the separate personality doctrine

The case of *Salomon v Salomon* [1897] AC 22 is by no means the first case to depend on the separate legal personality of a company, but it is the most widely discussed in this context. Mr Salomon was a boot and shoe manufacturer who had been trading for over 30 years. He had a thriving business. He also had a large family to provide for. To enable the business to expand, he turned it into a limited liability company. As part of the purchase price, he took shares in the company and lent the company money in return for 'debentures', which are paid off preferentially in the event of liquidation (see Chapter 13). The company did not last very long. Almost immediately, there was a depression in the boot and shoe trade and a number of strikes. Mr Salomon tried to keep the company afloat by lending it more money and by transferring his debentures to a Mr Broderip for £5,000, which he handed over to the company on loan. However, liquidation was not long in coming. The sale of the company's assets did not realise enough to pay the creditors. The liquidator claimed that the debentures had been issued fraudulently and were therefore invalid. He also denied that the business had been validly transferred from Mr Salomon to the company. The grounds for both these claims were that the business had been overvalued at £39,000 instead of its true worth of around £10,000 and that the whole transfer to a limited company amounted to a scheme to defeat creditors.

The judge who heard the case first admitted that the transfer had been legally carried out and could not be upset. However, he suggested (*Broderip v Salomon* [1895] 2 Ch 323) that Mr Salomon had employed the company as an agent and that he was therefore bound to indemnify the agent. He said that the creditors of the company could have sued Mr Salomon despite the existence of the company to which the business had been legally transferred. In the Court of Appeal, Mr Salomon's appeal was dismissed. However, the House of Lords took a different view. Lord MacNaughten said:

> The company is at law a different person altogether from [those forming the company] and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act … If the view of the learned judge were sound, it would follow that no common law partnership could register as a company limited by shares without remaining subject to unlimited liability.

Thus was established the complete separation between a company and those involved in its operation. As with many principles of English law, having established first the principle, we then must then look at the problems caused by and the exceptions to that principle.

1.5.3 The fundamental importance of separate personality

The invention of the company as separate is vital, as it means that it is free to develop as an instrument of business shaped by both the people involved in its running and those regulating its existence. That different models of companies have come to exist is a direct result of the fact that the company's separate personality sets it apart from the individuals who are running it. Although many people believe that the shareholders of a company are the 'owners' of the company, in fact the shareholders are not the owners of the property of the company. The property of the company is vested in the company itself. The company is a legal fiction; it is a legal person. The shareholders have rights in the company but not ownership of the legal person, the company. The shareholders own shares and because of that the law and the constitution of the company regulate shareholders' rights. Shareholders' rights are limited by the law, although the articles and the memorandum (the company's constitution – see Chapter 3) may allow shareholders less or more power when the documents founding the company are drafted. The backdrops of the shareholders' rights are the mandatory sections of company law.

In the UK, company law is a contractual model. This means that the shareholders in the company are the paramount stakeholders of the company, although the Companies Act 2006 has softened the hard contractual edge, allowing directors to consider other stakeholders' interests. Other jurisdictions have other models. Those that have developed in different states say a great deal about the society in which they operate. Chapter 2 considers this concept, normally called corporate governance, in more detail.

1.5.4 Problems caused by the personality doctrine and exceptions

The first 'personality' problem that may arise is that experienced by those seeking to form a company in order to carry on a business. While they are completing the formalities that will lead to registration of the company and the consequent gain of legal personality for the company, its creators may wish to sign contracts for the benefit of the company when it is formed. The difficulty is that the company does not exist as a legal person until registration and therefore cannot be party to any contract; neither may it employ agents to act on its behalf. The law on such 'pre-incorporation contracts' is explained in Chapter 4.

The second problem is the one under discussion in *Salomon*'s cases (Section 1.5.2). A limited liability company can be a very powerful weapon in the hands of someone determined on fraud and on defeating a creditor's rightful claims. Will the courts make no exceptions to the rule that a company is wholly separate from those who manage and control it? A survey of the case law shows that the courts do relax the strict principle of the separateness of the company from time to time. There is general agreement among those who have sought to analyse the relevant cases that the only principle that can be gleaned from the decisions is that the courts will look at the human reality behind the company if the interests of justice provide a compelling reason for doing so. This may sound like an excellent principle, but when the huge variety of situations that are likely to arise is considered, such a vague notion makes it extremely difficult to predict what a court will do in any given case. When the existence of the company is disregarded, commentators

have referred to it as 'lifting' or 'piercing' of the veil of incorporation. There are a number of cases, discussed in Section 1.5.6, which are clearly relevant to the sanctity of the 'veil' of incorporation, but the whole of company law is riddled with examples of the validity of acts depending on the effect they will have on the members of a company. An example would be where the part of the constitution of a company known as the articles of association is changed; that change may be challenged unless it can be justified as being in good faith and for the benefit of the company as a whole. In order to determine the latter, the effect of the decision on the members of the company must be examined.

It is also said that the proper person to sue to redress a wrong done to the company is the company itself. However, there is an exception to this rule to prevent those in charge of the company causing damage to shareholders in a powerless minority, for example by taking the company's property. The examples in Chapter 10 clearly show the difficult task that those seeking to regulate a company have because of the doctrine of legal personality. The company must be given as much independence from its operators as possible; otherwise, it would always be subject to interference from a large number of (probably dissenting) voices and therefore be no less cumbersome than a partnership trying to operate by consensus. On the other hand, the law must always recognise the reality of the fact that the company can do nothing without human operators, and that those human operators may wish to hijack the company for their own ends, to the detriment of others who have money at stake.

1.5.5 Statutory intervention

The personality of the company is recognised and ignored at will by the legislature. Those drafting legislation do not seem to respect the principle as being sacrosanct in itself and look merely to the end sought to be achieved by particular provisions. This is a highly practical approach. The courts might do well to admit that the only principle running through their decisions is justice in the individual case and thus adopt a similarly pragmatic approach.

1.5.6 Lifting the veil

The separate personality of the company can have some unexpected and sometimes unwelcome effects. In *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1995] 1 BCLC 352, the defendant was a sole director of a company. Despite this, he was obliged to make disclosure of a personal interest in a resolution that he passed purporting to terminate his contract of employment, although the court held that 'it may be that the declaration does not have to be out loud'. Although this sounds strange, it emphasises that the contract was one between the director and the company, so that in his capacity as an official acting in the interests of the company, the director must remind himself of his personal interest before determining a course of action. In *Macaura v Northern Assurance Co* [1925] AC 619, the court refused to ignore the separateness of the company and 'lift the veil', despite the fact that the consequence of so doing was to deny a remedy to someone whose personal fortune had gone up in smoke. Mr Macaura had sold the whole of the timber on his estate to a company. He owned almost all of the shares in the

company and the company owed him a great deal of money. Mr Macaura then took out an insurance policy on the timber in his own name. When almost all the timber was later destroyed by fire, he claimed under the insurance policy. The House of Lords held that he could not do so. He no longer had any legal interest in the timber and so fell afoul of the rule that an insurance policy cannot normally be taken out by someone who has no interest in what is insured.

Sometimes, other rules of law may be used to mitigate the effects of the strict application of the doctrine. This was done in *Harrods v Lemon* [1931] 2 KB 157. The estate agent division of Harrods was acting as agent in the sale of the defendant's house. A purchaser was introduced and subsequently instructed surveyors to examine the house. The surveyors who were instructed were from Harrods' surveyors' department. The survey disclosed defects, as a result of which a reduced price was negotiated. The defendant had been informed prior to this of the fact that Harrods were acting on both sides of the sale. This would normally be a breach of the agency contract between the estate agent department and the defendant. The defendant, however, agreed to Harrods continuing to act for her. The two departments of Harrods were in fact completely separate. The judge (Avory J) agreed that there had been a technical breach of the agency contract between Harrods and the defendant. Although the two departments were completely separate, the company in fact was one single person in the eyes of the law. However, he also insisted that the defendant should pay Harrods, despite the breach, as she had agreed to their continuing to act despite having full knowledge of the breach.

The following cases provide a prime example of the way the courts will disregard the separate personality of the company if that will achieve a just result, but will equally keep the veil of personality firmly in place where that will benefit someone for whom the court feels sympathy. In *Malyon v Plummer* [1963] 2 All ER 344, a husband and wife had full control of a company. The husband was killed by the defendant in a car accident and the widow was unable to continue the business of the company. An insurance policy had been taken out on the man's life and £2,000 was paid to the company on his death. The shares of the company were therefore more valuable than they had been prior to his death. The plaintiff (widow) had received an inflated salary from the company prior to her husband's death. The court had to assess the future financial situation of the widow in order to set the amount of damages payable to her. It was decided that the excess of the plaintiff's salary over the market value of her services was a benefit derived from the plaintiff's relationship with her husband. It was therefore a benefit lost by his death and only the market value of her services should be taken into account in assessing her future position. This ignores the fact that she was employed by a company that should, in accordance with *Salomon*'s case, have been regarded as an entity completely separate from both husband and wife. It did mean, however, that the widow got more because the compensation was assessed in a way that included the inflated wage rate. The wage rate should have been assessed by the company, not by the husband, because the company should have been completely separate. Similarly, the court held that the insurance money was money that should be regarded as having been paid to the wife as a result of the death of the husband. The shares owned by the wife therefore should be valued at the lower value before the £2,000 was paid.

It is very difficult to see a distinction in principle between *Malyon v Plummer*, where the veil was not just pierced but torn to shreds, and *Lee v Lee's Air Farming* [1916] AC 12, where the emphasis was laid heavily on the separate legal personality of the company. In this case, the widow would have lost everything if the *Malyon v Plummer* approach had been adopted. In *Lee*, the appellant's husband was the sole governing director and controlling shareholder of a company. He held all but one of the shares in the company. He flew an aircraft for the company, which had taken out an insurance policy that would entitle his widow to damages if, when he died, he was a 'worker' for the company. He was killed in a flying accident. It was held that the widow was entitled to compensation. Lee's position as sole governing director did not make it impossible for him to be a servant of the company in the capacity of chief pilot, because he and the company were separate and distinct legal entities that could enter and had entered into a valid contractual relationship. The reasoning in *Lee* was followed in *Secretary of State for Trade and Industry v Bottrill* [1999] BCC 177, where the Court of Appeal affirmed that a controlling shareholder could also be an employee of the company for the purposes of claiming under the Employment Rights Act 1996.

The approach in *Lee* was also followed in *Tunstall v Steigman* [1962] QB 593. There, a landlord was unable to terminate a tenancy on the ground that he was going to carry on a business on the premises because the business was to be carried on by a limited company. This was despite the fact that the landlord held all the shares in the company except for two, which were held by her nominees and of which she had sole control. The result in this case would be different if it was decided now, because section 6 of the Law of Property Act 1969 provides that where a landlord has a controlling interest in a company, any business to be carried on by the company shall be treated for the purposes of section 30 of the Landlord and Tenant Act 1954 as a business carried on by him. The case remains useful, however, as an illustration of the way in which the courts have approached the question of corporate personality.

The corporate veil remained firmly in place in *Williams v Natural Life Health Foods Ltd* [1998] 2 All ER 577, where the House of Lords held that a managing director was not liable for negligent advice given by the company. Liability would arise only where personal responsibility for the advice, based on objective factors, had been assumed and there had been reliance on the assumption of responsibility. This had not been established, despite the fact that the director had played a significant part behind the scenes in negotiations leading up to the grant of a franchise that the plaintiff purchased on the faith of financial projections furnished by someone introduced by the director and misrepresented as having relevant expertise. A brochure issued by the director's company had placed particular emphasis on the personal expertise and experience of the director. There were, however, no personal dealings between the managing director and the plaintiff.

1.5.7 Fraud

The ability to hide behind the corporate veil could be a powerful weapon in the hands of those with fraudulent tendencies. The courts have therefore always reserved the right to ignore a company that is formed or used merely to perpetrate a dishonest scheme. In *Salomon*'s cases, both the Court of Appeal and the judge at

the first instance thought that they had before them just such a case of fraud. Since there was no evidence of dishonest intent in that case, it seems that these courts were using 'fraud' in a very wide sense. Indeed, they seem to have regarded the formation of the company so that the business could henceforth be carried on with limited liability as sufficient evidence of 'fraud'. To take such a wide view would defeat the whole notion of the separate existence of the company and make it impossible for small private companies to function in any way differently from partnerships. The importance of the decision in *Salomon* in the House of Lords is clear. A mere wish to avail oneself of the benefits of limited liability is not of itself to be regarded as fraudulent.

A different view was taken of the conduct in *Jones v Lipman* [1962] 1 All ER 442. In that case, the first defendant agreed to sell land to the plaintiffs. When he later wished to avoid the sale, he formed a company and transferred the land to it. The court held that the company was a 'cloak' for the first defendant and that he had the power to make the company do as he wished, and therefore the court would order the transfer of land to the plaintiff. In *Trustor AB v Smallbone* [2001] 1 WLR 1177, the defendant, the managing director of Trustor AB, transferred funds from the account of Trustor AB to another company, Introcom Ltd, incorporated in Gibraltar, which was owned and controlled by him via a Liechtenstein trust. The board of directors did not authorise such a transaction. A part of these funds had found its way, via Introcom, to the defendant personally. The Court stated that:

> Introcom is liable, as constructive trustee, to account for and repay to Trustor the Trustor moneys that were paid to it … Introcom was the creature of the defendant. He owned and controlled Introcom. The payments out by Introcom of Trustor money were payments made with the knowing assistance of him … the defendant would be liable jointly and severally with Introcom for the repayment of that money with interest thereon. The defendant's joint and several liability would not be confined to the part that he personally received … the defendant is, in my view, clearly liable, jointly and severally with Introcom, for the whole of the sums for which Introcom is accountable.

The defendant was therefore found personally liable to return the funds in question on the basis that Introcom functioned as a façade used by him principally to misappropriate Trustor's funds. He tried to hide behind the corporate veil to escape his obligation to return the misappropriated funds, but the court held him personally liable.

Similarly, in *Gilford Motor Co v Horne* [1933] Ch 935, the court refused to allow the defendant to avoid an agreement that he would not compete with former employers. He had attempted to do so by competing with them in the guise of a limited company. Even clearer cases were *Re Darby* [1911] 1 KB 95 and *Re H* [1996] 2 BCLC 500. In *Re Darby*, the corporation was simply a device whereby a fraudulent prospectus was issued and the directors of the company pocketed the public's money. The directors were prosecuted for fraud and convicted. The court held that the directors were liable to repay all the money that had been received by them via the company. In *Re H and Others (restraint order: realisable property)* [1996] 2 BCLC 500, two family companies had been used to defraud the Revenue. The assets of the company could be treated as the assets of their fraudulent owners and seized.

Summary

1.1 There are several types of company. The most common is a limited company, the liability of the members being limited to the amount they have previously agreed. There are some unlimited companies where members are liable to pay the whole of the debts of the company.

- Companies may have a share capital or be limited by guarantee. In the former case, members buy shares. In the latter case, members agree to contribute to the debts of the company up to a certain amount.
- Companies may be public companies (PLCs) or private companies (normally having 'Ltd' after their names). Only public companies can offer shares to the public. Public companies are subject to more regulations than private companies; their shares are traded on a recognised stock exchange.
- Ready-made companies may be bought.
- Community interest companies (CICs) may be created for the use of people who want to conduct a business or other activity for the benefit of a community and not purely for private advantage.
- There is a minimum capital requirement for public companies of £50,000.

1.2 A company must have a memorandum of association.

- The choice of the name of a company is important and subject to a number of restrictions. Incorporation is achieved after the memorandum and articles are delivered to the Registrar of Companies.

1.3 Companies can change from public to private status and vice versa.

1.4 A group of companies is a number of parent and subsidiary companies where the parent normally exercises control over the subsidiary. The relationship between parent and subsidiary raises a variety of delicate legal issues.

1.5 The doctrine of corporate personality means that the identity of the company stays the same, even if the identities of the managers or members (shareholders) of the business change.

Exercises

1.1 What is the difference between the various types of companies?

1.2 What matters should be considered when choosing a name for a company?

1.3 What information is needed by the Registrar on the incorporation of a company?

1.4 When does a company come into existence?

Further reading

Sealy and Worthington, *Cases and Materials in Company Law*, 11th edn (Oxford University Press, 2016).

Mayson, French and Ryan, *Company Law*, 35th edn (Oxford University Press, 2018).

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