

Business Law: CIMA Year One
Lifting the Veil of Incorporation

The concept of a company being a legal entity can sometimes give undesirable results. In particular, shareholders could use a company to obtain funds dishonestly, and then not be liable for repayment.

There are therefore numerous exceptions to the rules defined by *Salomon v Salomon & Co Ltd*. These can be implemented by the courts on a case-by-case basis, or by statute.

Exceptions implemented by the courts

Since the courts rule on a case-by-case basis, it can be difficult to classify the exceptions. Generally, courts will intervene where justice demands it. Some examples of this include:

- a) In cases of fraud or sham. These occur where individuals have used the separate legal entity to do something they are personally forbidden from doing.

Gilford Motor Co Ltd v Horne (1933)

H was a car salesman, and left G. His contract stated that he wasn't allowed to sell to G's customers for a period after leaving. H set up a company which then approached his former customers; H argued that firstly his company was approaching the customers, not him; and secondly, if there was wrongdoing, his company was liable and not him. The courts held that the company was sham, and granted an injunction against his company as well as him.

Catamaran Cruises Ltd v Williams (1994)

W was employed by C. W set up a company and C then subcontracted with this company, paying the company W's wages gross of tax. W worked and had the same benefits as all other employees of C. C ended their contract with W's company, but the courts held that this was the same as dismissing W directly, and W was able to sue for unfair dismissal (however, W lost this case, since the dismissal was held to be fair).

- b) When the courts recognise an *agency relationship*. If a subsidiary company is acting as an agent for its holding company, it may be bound by the same liabilities and rights of its holding company. However, no court has yet found subsidiary companies liable for their holding company's debts.

Smith, Stone & Knight Ltd v Birmingham Corporation (1939)
SSK owned some land, and a subsidiary company operated on this land. BC issued a compulsory purchase order on this land. Any company which owned the land would be paid for it, and would reasonably compensate any owner for the business they ran on the land. Since the subsidiary company did not own the land, BC claimed they were entitled to no compensation. The courts held that the subsidiary company was an agent and BC must pay compensation.

- c) When the entities are considered to be a single economic unit.

DHN Food Distributors Ltd v London Borough of Tower Hamlets (1976)
A subsidiary company of DHN owned land which LBTB issued a compulsory purchase order on. The courts held that DHN was able to claim compensation because it and its subsidiary were a single economic unit.

Woolfson v Strathclyde Regional Council (1978)
This was similar to DHN v Tower Hamlets. However, the House of Lords ruled that Woolfson and its subsidiary were not a single economic unit due to operational practices. Note that since this case was based in Scotland, different law applied.

Adams v Cape Industries plc and Another (1991)
A worked for a US subsidiary of CI, which marketed asbestos in the US. The US subsidiary had no assets. A suffered injuries through exposure to asbestos dust and wanted to sue. If he had sued the US subsidiary, he would have received no compensation since there was no money to pay out. He therefore sued CI in the UK and claimed that the company was a single economic unit. The courts held that, even though they recognised that the corporate structure was designed to minimise liability and taxation, it was not illegal and should not be considered a single economic unit.

- d) Under *European Union law*, the European Court of Justice can consider subsidiary companies as a single unit for competition purposes. If there was a monopoly which set up ten subsidiaries to make it appear as if there was competition, the ECJ could consider all companies to be a single economic unit.
- e) In cases of *national emergency*, the courts may need to consider ownership of companies.

Daimler Co Ltd v Continental Tyre and Rubber (GB) Ltd (1916)
C sued D for debts owing. C was a UK company; however all shareholders but one) were German. D argued that they should not pay the debt to German individuals to prevent money going towards Germany's war effort. The court held that C was German.

- f) When companies have been set up for *tax evasion* purposes. Companies may transfer assets between subsidiary companies to reduce tax liability, but the courts may then treat them as a single unit.

Exceptions implemented by statute

The Companies Act 1985 includes a number of exceptions to the general rule imposed by *Salomon v Salomon & Co Ltd*.

- 1) A public company must have at least two members. If there is a single member (who is aware he is the only member) for more than six months, he is personally liable for any debts incurred during that period.
- 2) Groups of companies must produce accounts acknowledging their internal relationship, and profits and losses of different subsidiaries can be offset for taxation purposes.
- 3) Under the Transfer of Earnings and Protection of Employment Regulations (XXX), if an employee transfers from one company to a sister company, their period of employment is held to be continuous.
- 4) Employees of a company can be liable for the company's actions in some circumstances:
 - A public company must have an s117 certificate. If it operates without one, a director may be personally liable for any debts incurred.
 - A company cheque must bear the name of a company exactly, otherwise the director who signs is liable if the cheque is not cleared. This applies even if the omission is due to a printing error. A director of Michael Jackson Ltd was personally liable for a cheque he signed bearing the company name M Jackson Ltd.
 - If a company is wound up, its director may not carry out similar business with a similar name for five years. Double glazing companies are a good example of this; before his legislation, directors would pay themselves high bonuses and run a company into the ground, then would buy the assets of the insolvent company cheaply and set up a virtually identical company with a similar name to transfer any goodwill.

- Under the Company Directors Disqualification Act 1986, a person who is disqualified from being a director can be personally liable if they act as a director during their disqualification period.
- If directors know a company is close to insolvency but continue trading, they may be personally liable. For example, Courts Furniture Ltd recently continued taking orders and deposits despite the directors knowing the business was close to closing.