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Mini Review

SEPARATE LEGAL ENTITY OF CORPORATION: THE CORPORATE VEIL

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Abstract

The concept of separate legal entity is 500 years old and it means that the corporation is separate in all spheres of its activities. It is separate from its owner, from its employees and due to this separation between the corporation and an individual the shareholders' liability is also limited. A corporation is established through four different ways i.e. continuity, self-governance, identification persona, and specification of assets. The personhood of a corporation is evolved with the passage of time through different court judgments in which Salomon case plays the role of corner stone. The corporation can own, sell and buy property in its name. The corporation can sue and be sued in the court of law as a legal person.

Keywords: Corporation; shareholders; separate legal entity; Limited liability; corporate veil.

Historical Evolution of Corporate Personhood

The history of corporation is very old and its study shows that in earlier stages corporation were not meant for the purpose of business and trading but they were established, in the middle age of Europe, for religious and church institutions. These institutions got their authority through charters granted by local lords and kings. Charters were granted for the purpose to hold property. This ability of institution to hold property in their own name assured that the property held by such institution is the sole property of that very institution and not of those individual or their legal heirs who control such institution. These properties were also not subjected to heavy taxes. After granting of the royal charter, the property owned by such institutions could not be reverted back to the estate of the lord. Later on in 16th century the range of granting charter to the institutions was extended and other institutions such as hospitals, universities, colleges etc were also granted charters. The purpose of those incorporations was perpetual succession and that succession of different individuals to be recognized as a single legal person. But till that time the corporations were not used for commercial purposes. (Ron, 2000)

Single individuals like kings, bishops etc were involved in certain type of corporations. They were known as sole corporations. The purpose of the incorporation of these corporations was to make it clear and known to the public that the property hold by the person is not their own property but they are for the public purpose and the contracts made, if any, were not in personal behalf but were made in their official capacity (Blair, 2012). All of these corporation were known as "aggregate corporations"

In 17th century for the first time in England, charters were issued to trading companies for commercial purpose (Blair, 2012). Trading companies were actually contractual partnerships recognized at common law and did not required charter. By the end of 17th century several companies were established.

There are four means through which the personhood of a corporation can be established:

Providing Continuity

This means that a corporations continuous its business, holds its property and carry out its contracts without any gap, the legal entity continuous to exist over the time even if the owner dies or withdraw its assets from the corporation. The life of corporation is immortal which means that the corporation runs its business smoothly without any gap until winded up through a procedure. (Trustees of Dartmouth College v. Woodward, 1819)

Providing an "Identifiable Persona"

From identifiable persona, here it means the name through which the corporation is known. The name of the corporation serves as a legally liable person who carries out the business activities. The persons involved in the corporation are known by the name of that corporation. The name is the intangible asset of the corporation such as franchise, monopoly rights, reputation, image brand etc. These intangible assets are the valuable source of corporations. (Blair, 2012) This persona is used in all contracts and a corporation can sue and can be sued in this persona.

Specification of Assets

There should be a mechanism through which the assets of the corporation are separated from the assets of the shareholders, and it should be also specified that what assets are dedicated to the business. This separation of assets makes it very easy for those peoples who want to invest or participate in the enterprise and it also makes it certain and known that, in case of dissolution of the corporation, a person will have to bear a specific amount of loss (Limited liability principle).

Self-Governance

For a legal entity status a corporation should have a mechanism and capacity through which they govern their internal affairs. The corporation should have the ability to make decisions for their internal governance. (Blair, 2012)

Corporation is a Legal Entity

Corporation is a legal entity means that corporation, in the eye of law, is considered as a legal person having certain rights and duties under the law. Every state has its own separate corporate law through which the corporations are governed but certain principles in corporate law are universal and are worldwide like corporation has the right to buy the property and sell the property owned by the corporation. If any tort has been committed or any breach of contract has been made either by the corporation or by the counter-party, the aggrieved party can bring a suit against that party and enforce contract against the other party who has violated any term of the contract--if enforceable-- and if the contract cannot be enforced specifically then the aggrieved party will be compensated in accordance with law. Certain restriction has also been imposed on the corporation by law. A corporation is a juridical legal person and it cannot hold any public office , cannot cast there vote in a general elections, cannot participate in the election, corporation cannot interfere in the affairs of the government. There are certain similar points between juridical (legal) person and natural person (Schane, 1986).

The word "person" used in a statute will always mean either the juridical person (corporation) or natural person as long as the interpretation fits with the general design and intent of the act.

Corporation is a juridical legal person and it should be treated as separate legal person. No person can claim to be the owner of a corporation; corporation is a legal person so no person can own another person. As a corporation, being a separate legal person, is separate from its members and shareholders so the shareholders of a corporation can become employees of that corporation and can get wide range benefits from that corporation in the shape of retirement plans, tax free medical benefits, meal, life insurance and many other benefits offered by the corporation to their employees. (Hofstrand, 2007)

Cases Establishing the Principle of Separate Legal Entity

Legal personality of a corporation or legal existence of a corporation as separate legal entity has been accepted from very primitive days and a lot of judgments have been passed from 17th century onward by different law courts recognizing the principle of separate legal entity of a corporation. There are numerous cases on this point. The prominent legal cases establishing the principle are:

Kandoli Tea Company Case (1886)

Facts of the case

There were certain persons in Kandoli Tea Company who transferred their properties in the name of the Tea Company with intent to avoid paying tax on that very property as tax was due on that property,

Petition

Petition was moved to the court of law in which they were claiming exemption from payment of tax on the ground that they did not have any taxable property on their name because the same has been transferred to the Kandoli Tea Company's name.

Judgment

The court of law after full scrutiny of the record available gave verdict that as company is a separate legal entity and the property is transferred to the name of the company so the same property should be treated as transferred and the petitioners are not liable to any kind of tax. (The Kondoli Tea Co. Ltd. vs Unknown , 1886)

Salomon v A Salomon Co. Ltd (1897)

The most prominent case in the history of corporation through which the corporation raises its authority as a separate legal person is Salomon case.

Facts of the case

In 19th century Mr. Salomon was a very successful trader of leather and his business was at the peak because he was the sole trader of leather at that time. There was no other businessman who could compete with Mr. Salomon business. Mr. Salomon then setup a company with 20007 shares, in these 20007 shares he purchased 20001 shares while the remaining 6 shares were purchased by his family members' i.e. by his wife and five children one each. After setting up a company Mr. Salomon sold his business to the company at 38,782 pounds. The company paid 20001 fully paid shares to Mr. Salomon and 8,781 pounds in cash, so the total amount paid by the company to Mr. Salomon was 28,782 pounds (both in shape of share and cash) and 10,000 pounds were remained payable to Salomon by the company, he secured his remaining loan through debenture. Mr. Salomon followed all the rules and regulations required for the incorporation of a company. In his company there were 7 members but the majority of shares were held by

Salomon. At the same time he was also the main creditor to the company.

Issue

At the time of winding up of the company because the company was failed, a question was raised in the court of law to decide that whether precedence will be given to the secured loan of Mr. Salomon over the non-secured loan of another creditor of amount 11,000 pounds?

If the court gave precedence to the secured loan over non secured loan then nothing would be left to the non-secured creditor because the assets of the company turned out very low. Only 7,000 pounds were the assets of the company at the time of liquidation.

Arguments

The liquidator appointed for winding up of the company argued that Salomon purposely transferred the business to the company. The liquidator also argued that the company acted as an agent of Salomon and therefore being the principal he is liable to pay the debts of unsecured creditor.

Decision of Court

After hearing the case and relying on the arguments of the liquidator the court decided that as the company was the agent of Mr. Salomon hence he was held responsible to pay all the debts to the creditors.

Court of Appeal

The appeal against the lower court decision was also turned down and the decision of the lower court was maintained on the ground that Mr. Salomon abused the privileges of incorporation and limited liability. The limited liability is available only to those peoples who are fair and devoted shareholders. Mr. Salomon did not incorporate the company with clear hands. He carried on the business of the company in the same manner as he was carrying his business when he was the sole trader.

House of Lords

The house of lord totally rejected the decisions of both the lower court and the court of appeal and established a corner stone principle for the modern company law. In the House of Lords it was unanimously held that corporation is separate legal entity, separate from its members and shareholders. All the requirements for a valid incorporation of a company were fulfilled. There were seven members who had subscribed to the memorandum of the company. Shares were held by all the subscribers and nothing more was mentioned about the independence. It was held by the House of Lords that Salomon Company was validly incorporated in accordance with law and therefore the debts of the company are its own debts and the members are not liable for the payment of the company's debts.

Result

Company as a legal person was lawfully created through observance of all the rules of the company law by the

shareholders. It does not make any difference that the company management is run by single person or all the shareholders and therefore preference was given to Mr. Salomon's debenture. (Salomon v Salomon & Co Ltd, 1896)

Macaura v Northern Assurance Co. Ltd (1925)

Macaura was the major shareholder of a timber company. Almost all the shares of the company were held by Macaura. At the same time he was also substantial creditor of the company. He insured the timber on his own name and not on the name of the company which owned the timber. Later on timber were destroyed by fire and when Macaura applied to the insurance company for the payment, the insurance company refused to pay on the ground that Macaura did not own the timber on his name and he is not the real owner of timber thus he could not claim payment. Salomon principle was applied to the case by the court and decided that as the timber were owned by the company and the company failed to insure the property on its own name so the plaintiff was not entitled to any payment.

The decision in this case, by the court of law, made it very clear that the property of the company is the sole property of that very company and no person has the right to interfere in the company's property and even the shareholders have no right to use the property without company's consent. The company has the right over that very property and it is at the disposal of the company either to sell or insure that very property. (Macaura v Northern Assurance Co. Ltd, 1925)

Lee v Lee's Air Farming Co. Ltd (1960)

Facts of the case

Mr. Lee was the managing director of a company incorporated by him. Being the managing director of the company he appointed himself as a pilot of the company. Lee died in a flying accident when he was going for a business of the company. The widow of Mr. Lee claimed compensation from the company on the ground that her husband has died in the course of company's employment. It was argued by the opposite party that Lee and Lee's Air Farming Ltd was the same person and therefore no compensation could be granted to the widow of Mr. Lee.

Judgment

It was held in the judgment of the court of law that 1) Mr. Lee was separate person from the company and he had only incorporated the company and therefore compensation was payable to the widow of Mr. Lee 2) as a company is a separate legal entity so a member of a company can enter into a contract with that company in which he is holding shares 3) the widow of Mr. Lee was entitled to compensation under the workmen's compensation act, 4) the director was not restrained from becoming the employee of that very company (Catherine Lee v Lee's Air Farming Limited, 1960).

The basic principle established by the court of law and now embodied in the company law is that company after its formation become a separate legal entity and it can appoint the owner or any other person to deal with the business of the company but they are considered as the agents of the company and are dealt separate from the company. (Anderson, 2004) this principle was established in the Salomon case, (Salomon v Salomon & Co Ltd, 1896) Thus an act by the member of the company in discharge of his duties toward the company must be considered as an act of the company because the person acting on behalf of the company is always considered as an agent of the company and all his acts are considered as committed by the company itself. Company is considered as a separate legal entity and that is why individual employees are protected. If a person was held personally liable for an act done on behalf of the company then, due to fear, no one would accept any type of responsibility. The concept of separate legal entity is for the purpose to encourage commercial enterprise and also to limit the risk associated with the company offices. (Fridman, 1992)

Conclusion

So from the above discussion it is concluded that corporation is a separate legal person, separate from its members and a firm after its proper incorporation through corporate law acquires a juridical status. A company can run its business through its representative and agents and all the transaction made by any member of the company will be considered the transaction of the company, if done by the person who is authorized to do it. The corporation can sell a property owned by such corporation and also can buy any kind of property. So the corporation has the contractual capacity and it can enter into the contract with any person even with its own employees and shareholders. If any of the terms in the contract is violated by either party both the parties has the right to approach the court. So the corporation can sue and can be sued.

The principal of separate legal entity was firmly established in Salomon's case and the same was applied to many cases.

This well-established principle set down in Salomon v Salomon & Co is known as the Veil of Incorporation. However certain restrictions have been imposed to this principal in order to prevent the abuse of limited liability protection.

The veil of incorporation may only be disregarded to avoid fraudulent and reckless trading or where the sole purpose for which the company was incorporated is fraudulent or illegal.

The court of law can disregard the corporate veil in order to ensure justice.

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