Law Dissertation Introduction Example

CHAPTER – 1

INTRODUCTION

Limited Liability is one of the key elements that guaranteed the success of the modern company. Every person who invests his money in any business first of all, he has to see what profit should he get and how much he has to invest and what would be his liabilities if he does not get success? If the person has more liabilities then the profits he profits he earns, then he will not choose to invest his money and not ready to bear the loss more than his share. So, the concept of limited liability, though, it is accepted after the long dispute is really for the benefit of individuals and the companies. Today's world is a mercantile world, everyone wants to get more and more profit but with less liabilities.

The Limited liability of the corporate shareholder is a traditional cornerstone in the corporation law of the civil system. The doctrine of limited liability protects the ultimate investor in the business from the liabilities of the enterprise in excess of the investor's capital investment. Limited liability meant that the shareholders were only liable to the money they invested in the company rather than liable for their whole wealth[1].

Limited liability seems to have allowed a greater diversification of the body of shareholders. If shareholding exposed one to liability, it was good to restrict one's shareholding to one or two companies. Once liability became limited, investors could spread their investments by buying smaller, non-controlling stakes in more companies. Shareholding became more affordable, attracting new investors to the market. These developments heralded the end of direct shareholder involvement in the management of companies. Management power gradually passed from the shareholders to a new group of professional company managers, thereby creating one of the corporate governance dilemmas of the modern company[2].

The project will examine the past position as well as present position of the liability of the shareholders towards the company. When might be the shareholders of the limited company become liable to pay money to the company or the creditors of the company in excess of the amount which the shareholders have paid and agreed to pay to the company for its shares?

Within Company law, the notion of limited liability is very technical and often gets misunderstood. Sometimes it has been wrongly referred as 'Corporate' Limited liability; it is the principle as a result of which the members of an insolvent company do not have to contribute their own money to the assets in the liquidation to meet the debts of the company. Under the Insolvency Act, 1986 the members have a liability to contribute to the assets of the company in the event of its assets in the liquidation being insufficient to meet the claims of the creditors. It is this liability which is limited. Traditionally, the doctrine of limited liability is conceived of as concerning itself with the protection of the shareholder's assets, but functionally it can be seen as a wider concept. During the insolvency of the company, the creditors have the remedy that they can sue the company but the Shareholders even don't have this right. They have to bear overall loss in the insolvency of the limited company. The main argument against the concept is that limited liability encourages recklessness in business ventures and innocent creditors have to bear the loss[3]. The project will examine the problems faced by the creditors of the company.

In various situations, the shareholders have to become liable to pay money to the company or the creditors of the company such as if the company formation was done with the shareholder also being a director of the limited liability company and if the shareholder has subsequently given a personal guarantee of the limited company's debts or obligations, the Shareholder could become personally and directly liable to the company's creditors for such debts or obligations of the limited company. Limited Liability Company helps to run business even in the worst condition, that the company is unable to pay its debts even in that condition the company is running and its directors haven't been affected by its insolvency and liquidation but the shareholders have the biggest effect in those condition as they have investments in those companies.

Does the limited liability company still justify its original economic objective in benefitting the economy and society as a whole? An overview of the future of this area of the law will also be investigated.

The project will also explain corporate veil. Company as a separate legal entity distinct from its members. This principle is established in the famous case of Salomon v Salomon Ltd [1897] AC 22. Professor Sealy described Salomon principle as 'the cornerstone of Company law'. In this project, we also discuss under what circumstances, the Courts can lift the corporate veil. What is the common law and statutory law says about the lifting of corporate veil? Is it an exception to the concept of limited liability or against it?

Today's world is a competitive world and many of the multinational companies organized in the form of a parent corporation with hundreds of subsidiary corporations. Most of the world's business is conducted by the subsidiaries. When we talk about corporate groups, limited liability protects not only the ultimate investors from the debts of the enterprise, but also each of the corporations into which the enterprise has been fragmented. Each corporation is protected from liability for obligations of the other fragments of the enterprise. Limited liability for the business has become limited liability for each of the successive tiers within the enterprise. According to traditional doctrine, such corporate groups enjoy the same benefits of limited liability as the common law has historically afforded to the individual investor in a corporate enterprise. In light of recent environment disasters of worldwide dimensions, re examination of the traditional doctrine of limited liability as applied to corporate groups has emerged as an issue of major importance. [4]

Limited liability serves certain underlying policies that are intended to achieve certain objectives. In certain circumstances in which the application of limited liability no longer appears to serve such policies or contribute to such objectives, limited liability, like any other legal rule that does not serve its presumed purposes, must be re examined critically. This re examination is particularly important in the case of corporate group where entity law, the traditional view of corporation law, is already in the process of erosion in areas such as procedure and bankruptcy, where imposition of substantive liability and rejection of limited liability generally is not involved.

Chapter 1 examines the history and origin of the limited liability company. This concept developed in the 17th century. Before this, people were scared to invest in companies because of the risk involved during which any investor in partnership organization could have been easily held accountable for all the debts and losses of the company. By that time concept of limited liability had not been associated with the corporate world. The universal concept is first adopted in the US in the early 19th century, then in English law in 1855 via Limited Liability Act and it is always be the universal feature of corporate form.

Chapter 2 examines the corporate personality of the company. The company as a separate legal entity distinct from its members. The principle of separate identity is known as the ''veil of incorporation'' and allows larger parent companies to own subsidiary companies, yet not to be responsible for any of their liabilities but where the court found that a parent company was responsible for the actions of a subsidiary in relation to an employee, it will not hesitate to lift the veil.

Chapter 3 explains the corporate veil with the help of the famous case of Salomon v Salomon. What is the relevance of Salomon principle?

Chapter 4 explains about the advantages and disadvantages of limited liability. Arguments for limited liability and legal responses to limited liability. I'll try to suggest some reforms so that steps should be taken to improve or develop the concept or how the concept becomes more efficient and effective in the future. If no reforms suggested then our research will not be considered as complete or it is of no worth.

Chapter 5 deals with the conclusion that what we achieve through our research and how far our objectives are fulfilled.

History of limited liability

The modern companies in their present form originate from the earliest form of corporate entity, namely the sole trader. From the Middle Ages, such traders were regulated by merchant guilds which oversaw a diversity of trades. The internationalization of trade, with traders venturing overseas, led gradually to regulated companies arising from the medieval guild system. Members of these early companies could trade their own shares in the company, which led ultimately to the formation of joint stock companies.[5] Incorporation by Royal Charter was relatively rarely given to traders. The original purpose of incorporation by Royal Charter seems to have been to confer protection and status. The grant was often for charitable purposes. Later, in the Elizabethan period, the dominant purpose was to regulate a particular trade. This became necessary when the guild system had declined and become the subject of abuse. Some of these grants amounted to monopolies. Underlying the grant was the idea of public purpose. The concept of public purpose and benefit in incorporation declined due to a number of factors- the Stuart abuse of the Royal prerogative, the increase of trade and manufacture and the growth of overseas trade, originally as privateering expeditions. This is the beginning of the rise of capitalistic enterprise whose dominant characteristics is to produce a more open economic group. With the development of overseas and colonial trade, merchant venturers also rise. The merchant ventures' gave rise to 'regulated companies' which extended the guild system into overseas trade. From the beginning of the 15th century the Crown made extensive grants of privileges to companies of merchants trading overseas. Later these were Royal Charters providing for incorporation and a monopoly of trade in a particular region. The objects of such grants are to provide for proper organisation for the trade, to develop a new trade or colonisation. The interest of merchants was not in separate legal personality as such so much as the exercise of governmental power and trading privilege[6].

The concept of Joint stock came into being. This concept historically seems to have been linked with the grant of a monopoly. The grant is made to a 'company' of individuals who raise stock for the exploitation of the monopoly. Joint stock represents a combination of association and exploitation of a privilege. This concept was particularly useful with overseas trading ventures. The first company to combine incorporation, overseas trade and joint stock was the East India Company, which was granted a Royal Charter in 1600, for Merchants of London trading into the

East Indies. This development was summed up well by a Committee of the House of Commons in 1604[7]. ‘A whole Company, by this means become as one man’. Although some joint stock ventures obtained incorporation, many did not and were in essence partnerships describing themselves loosely as ‘companies’. Stocks and shares in both incorporated and unincorporated ventures began to be dealt in on the developing stock market which Parliament found it necessary to regulate in 1696. By the beginning of the 18th Century, therefore, there was considerable diversity in the forms of business organisation and added to this there was some trade in the charters of defunct chartered corporations[8].

International trade and interest in investment overseas led to the infamous South Sea Bubble of 1720, where the general public in Britain who had invested in ‘shares’ in the Company of Merchants of Great Britain Trading to the South Seas, realized they had lost their hard earned money in the first stock market overvaluation and subsequent collapse. At one point during the Bubble’s growth the amount invested in companies involved in the South Seas reached £500 million, double the value of all the land in England at the time. Investors did not realize the lack of solid foundation underlying their investment. The bubble in UK information technology stocks in the late 1990s was another example of investor irrationality and the ways in which the markets could be fooled. The Bubble Act followed the bursting of the South Sea Bubble prevented companies from acting as a body corporate and from raising money by selling shares without the legal authority of an Act of Parliament or Royal Charter. Inevitably, this stopped the development of joint stock companies. The South Sea Bubble and the resulting Bubble Act set back the development of joint stock companies for some time[9].

The ‘deed of Settlement Company’ drafted so as to comply with the Bubble Act. This was a combination of trust and association. Its assets were held on trust by trustees but its business was managed by managers or directors. In the early nineteenth century, after a crop of cases on the Bubble Act, an enquiry was carried out into the working of the Act and it was eventually repealed in 1825 at the behest of the Board of Trade. There was nevertheless doubt as to the legality of deed of settlement companies at common law until 1843[10]. The deed of Settlement Company when registered was invested with the qualities and incidents of corporations, although the full effect of this was not recognised until later in the nineteenth century. The effect of this legislation was to shift from privilege of incorporation to the right of incorporation provided the statutory conditions were fulfilled[11].

It was the development of the railway network in Britain in the 1800s that instigated the development of modern companies as they needed to attract funds to feed their growth. 910 companies were registered from the introduction of the first modern Joint Stock Companies Act in 1844. However, these companies were ‘unlimited’. This implied that their shareholders bore unlimited liability for their investee company’s debts and this was not an effective means of encouraging people to place their monies into the hands of company management. This came with the Limited liability Act of 1855. Limited liability implied that the shareholders could only lose the amount they had invested in the company, rather than be liable for their entire wealth as it happened in unlimited companies. These events represented a major breakthrough for the growth of capitalism. This was introduced as a progressive reform measure aimed at revitalizing British business, as at that time companies were seeking incorporation in the USA and France in preference to the UK in order to obtain limited liability for their shareholders. The number of incorporations rose dramatically[12].

In accordance with the Limited Liability Act 1855, a company was required to have not less than three-quarters of its nominal capital subscribed and the word ‘limited’ added to its name. Liability

was limited to the nominal value of the share. The 1855 Act was incorporated into the Joint Stock Companies Act 1856 which required an obligation on the part of a company to have and register constitutional documents namely the memorandum and articles of association. In order to encourage smaller business enterprises to register as a company, the 1856 Act removed the restrictions relating to the minimum amount of capital to be contributed by members of a company and also reduced to minimum number of members required for the purposes of incorporation from 25 to 7 members.[13]

After the Limited Liability Act 1855, limited liability was provided as well as a simplification of the registration requirements for incorporation. In UK, two types of Limited Liability Companies i.e. 'Ltd' for a private company or 'PLC' for a public company attached to the company's name to signify that the members of this company have limited liability. In other words they are not liable for the debts of the company. 'Ltd' or 'PLC' refers only to the member's liability and not that of the company. The company itself is liable for its debts. The creditors cannot go after the member's assets to satisfy their claim. Legal personality of the company and its members are different. The corporate assets belong to the company and the member's assets are their own assets not belong to the company.

1855 and 1856 Acts allowed entrepreneurs to freely set up Limited Liability Companies to get benefits. New businesses were formed and the expansion of the existing businesses took place for eg. Vale of Belvoir and Newark Plaster, Cement and Mineral Company Ltd. In 1865, an established gypsum plaster manufacturer and a stockbroker identified an opportunity and immediately started building a large mine and factory which was largest in Europe at the time and financed by an offer to the general public of its shares but due to the Overend Gurney scandal[14] and the sudden loss of popularity of limited liability the floatation was unsuccessful (Barnes and Firman, 2002).[15]

Limited liability became effective under the 1856 Act. Between 1856 and 1862 nearly 2,500 limited liability Companies were registered and between 1863 and 1866 3,500 more of which 900 offered shares to the general public (Shannon, 1932). By 1865, The Times expressed that 'the whole country, if not the world, was growing everyday into ''one vast mass of impersonalities.''' Crucially, it was led by the promotion of limited liability banks and finance companies in which Parisian fashions in finance blossomed.

As The Times remarked, 'There arose a new institution…………The Finance Companies or Discount companies, or general Trading Company, or simple bank, emerging from the straight – laced chrysatis into the gaudy and volatile butterfly ,in the form of a company limited, and for the express purpose of sharing the profits of trade, [combined] in one bank, he discounter, the railway, the iron master, the merchant, the stock jobber and that specious form of limited liability which induces the hope of profits on a very large sum with the risk of a very small one.' (May 1866)[16]

Within the year, the 1856 joint stock companies Act had increased the availability of limited liability to ordinary and small businesses enormously. It not only dispensed with the minimum capital requirements but enabled associations of merely seven to incorporate. The significance of the Act was readily clear but few contemporaries realised how far it would enlarge the scope of the Company legal form.[17]

In spite of its permissiveness, it is proved that the proponents of the Joint Stock Companies Act, 1856 did not intend it to make the newly constituted company legal form available to 'private' partnerships or to sole traders. Robert Lowe, while introducing the joint stock companies bill to

the Commons stressed that the joint stock companies bill was meant to amend the law relating to joint stock companies only and clearly rejects the extension of limited liability to partnerships and sole traders through the widening of its scope to associations of fewer than seven. He argued that in spite of granting limited liability to such enterprises just incorporate them and it would render their acts open to 'constant ambiguity.' Lowe also did not believe that the company legal form as reconstituted by the joint stock companies' bill should accept small partnerships or sole traders nor that it would seven meant seven.[18]

Alexander Hastie, a staunch opponent of limited liability, argued that the Bill could be used or abused by associations fewer than seven or by small businesses in which an individual merely had to give a single share to six others. Its broad application was also recognised by many outside Parliament.

Edward Cox, a barrister in his legal guide to the Act was also very critical. In his view, the improvements of the law were 'at the price of enormous evils' in which limited liability, 'immoral in itself', permitted a trader to speculate for unlimited gain without being liable for more than a small and definite loss.[19]

The Joint Stock Companies Act, 1856 soon precipitated a dramatic change in the legal organisational forms of British Industry. In the late 1860's, therefore, the Company legal form was still being used by joint stock companies, all joint stock companies were now legal companies it means that the 'company' now had both economic and legal form i.e. the company was joint stock company as well as incorporated limited liability.[20]

The use of the term 'private company'[21] to describe incorporated small partnerships and sole traders was soon institutionalised. The rise of the private company in the 1880s was probably one of the main reasons behind the increase in company registrations. By the 1890s also, the limited company was becoming more common primarily because of the rise of the private company. The major shift to limited company legal form could not take place until '' public opinion had been convinced that a company was as good as a private firm.'' As the 1886 Royal Commission on the Depression in Trade and Industry revealed that there remained '' some strange virtue surrounding the private firm which a company could not acquire'', and the unlimited[22], 'private' partnership was defended against both the limited company legal form and the joint stock company economic form.[23]

The threat to the private company and further spread of the company legal form was double-pronged. First, there remained a minority who wished to confine the limited company form to enterprises of the joint stock type and to prevent its use by small partnerships and sole traders. Secondly, spread of the company legal form to economic partnerships and individual proprietorships came as a new breed of company frauds. But as the company legal form came to be utilised by individual proprietorships and economic partnerships seeking limited liability, it was increasingly creditors who became the victims of fraud as firms in financial difficulty incorporated. Critically, these new abuses strengthened the demand that all companies be made to publish an annual balance sheet and possibly even a profit loss account to protect creditors.[24]

To tackle such types of problems, the case of Salomon v Salomon[25] came to help. This case also established the applicability of the registered company as an acceptable and valid form of business, medium or small businesses.

In this case, A. Salomon was a leather boot and shoe manufacturer. He had a wife, a daughter and five sons. Four of the sons with him and they wanted to be partners so, he turned the business into a limited company. The wife and five eldest children became subscribers and two eldest sons also directors. Mr. Salomon took 20,001 of the company's 20,007 shares. The price fixed by the contract was £39,000 and the business was transferred on June 1, 1892. Purchase money for the business was paid, totalling £20,000 to Mr. Salomon. £10,000 was paid in debentures to Mr. Salomon as well. But soon after Mr. Salomon incorporated his business, there was economic trouble. Strikes in the shoe industry led the government. His warehouse was full of unsold stock. He and his wife lent the company money. He cancelled his debentures but the company needed more money. They sought £5000 from Edmund Broderip and gave him a debenture, the loan with 10% interest and secured by a floating charge. The business still failed and they could not keep up with the interest payments. In October 1893, Mr Broderip sued to enforce his security. The company was put into liquidation. Mr. Broderip was paid but other unsecured creditors were not. The liquidator met Broderip's claim with a counter claim, joining Salomon as a defendant that the debentures were invalid for being issued as fraud. The liquidator claimed all the money back that was transferred when the company was started, agreement for the business transfer was rescinded, debentures were cancelled and repayment of the balance of the purchase money[26].

In this case, In the Court of Chancery, Vaughan William J. argued that the signatories of the memorandum were mere dummies and the business was Salomon's, the Company ''a mere alias'' and his agent and that he was bound to indemnify it. Salomon's intention was to take the profits without running the risk of the debts and expenses and so one had to consider the position of the unsecured trading creditors. He further declared that the Company was Salomon's agent, ''a mere nominee'', and as such had a right of indemnity against Salomon for the debts which had been ''contracted at his bidding and for his benefit''. There was no allegation of fraud,'' but to allow a man who carried on business under another name to set up a debenture in priority to the claims of the creditors of the company would have the effect of defeating and delaying his creditors. There must be an implied agreement by Salomon to indemnify the company''. The creditors of the company could have sued Salomon directly.[27]

The Court of Appeal upheld the decision in the Broderip v Salomon. In his Judgment, Lindley L. J. recognised the importance of the appeal given the increasing number of one-man companies but insisted that an attempt had been made ''to use the machinery of the Companies Act, 1862 for a purpose for which it was never intended.'' Parliament had never considered an extension of limited liability to sole traders or to less than seven. Admittedly, there were seven members in the present case, but ''it is manifest that six of them are members simply in order to enable the seventh himself to carry on business with limited liability''. "The object of the whole arrangement", he said, "is to do the very thing which the legislature intended not to be done". It was a corporation "created for an illegitimate purpose", "to attain a result not permitted by law". He was also of the view that the relationship between Salomon and the Company was not that of principal and agent but that of trustee and cestui que trust[28] and the creditors could not sue Salomon directly but had to reach him through the company. The decision, he asserted, would leave many small companies "quite unaffected", but "there may possibly be some companies which, like this, are mere devices to enable a man to carry on trade with limited liability, to incur debts in the name of a registered company, and to sweep off the company's assets by means of debentures, which he has caused to be issued to himself in order to defeat the claims of those who have been incautious enough to trade with the company without perceiving the trap which he has laid for them".[29] Lindley LJ held that the Company was a trustee for Mr. Salomon, and as such was bound to indemnify the Company's debts. Lopes L.J. and Kay L.J. variously described the Company as a myth and a fiction and said that the incorporation of the business by Mr. Salomon had been a mere scheme to enable him to carry on as before but with limited liability. The implications of the

Court of Appeal decision for one-man and other private companies were much more serious than those of the lower court verdict.[30]

The Salomon decision was appealed and proceeded to the House of Lords and the Law Lords reversed the two earlier decisions. In this appeal, all the six judges interpret the relevant sections of the 1862 Act. The Act required seven members holding at least one share each for a company to be formed; it said nothing about their being ‘substantially’ or ‘beneficially’ interested, nor that they should not be trustees or should have ‘a mind of their own’. Lord Herschell’s comments were representative: “I know of no means of ascertaining what is the intent and meaning of the Companies Act except by examining its provisions and finding what regulations it has imposed as a condition of trading with limited liability. The memorandum must state the amount of the capital of the Company and the number of shares into which it is divided, and no subscriber is to take less than one share. The shares may, however, be of as small a nominal value as those who form the company please; the statute prescribes no minimum; and though there must be seven shareholders, it is enough if each of them holds one share, however small its denomination. The Legislature, therefore, clearly sanctions a scheme by which all the shares except six are owned by a single individual and those six are of a value little more than nominal………..While Companies such as Salomon and Co. may not, he said, have been contemplated by the legislature when the Act authorising limited liability was passed, it made no difference: ‘’we have to interpret the law, not make it….’’. [31]