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Unlocking the Power of Corporate Form: Exploring the Advantages of Incorporation

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ABSTRACT

A company is a "legal person" or "legal entity" which possess the potential to outlive its members unless liquidated either voluntarily or compulsorily. In essence, a company has a separate identity from its members. However, a corporation cannot be viewed exclusively as a legal entity. Instead, it is a legal device used to achieve a social or economic goal. With incorporation comes the concrete principle of separate legal entity and it is by virtue of this concept that incidents or consequences of incorporation holds ground. A business organisation, by incorporation, can limit their liability in respect of the debts thus reducing risk of potential charge by the creditors over their personal assets. However, over the years, there have been instances where the rule of separate legal entity was bypassed to reveal the true persons behind the corporate entity. In such circumstances, the rule of separate legal entity ceases to apply and the corporate entity becomes equivalent to its members. It is only under exceptional circumstances that the rule of separate legal entity is not honoured and the corporate veil is lifted. It cannot be stressed enough that in every possible circumstance, the sanctity of separate legal entity is to be maintained i.e., an incorporated body is to be treated as a separate entity independent of its members unless an exceptional circumstance crops up.

Keywords: *separate legal entity, incorporation, company, corporate veil, liability.*

I. INTRODUCTION

People who want to operate joint businesses have the option to choose between incorporating a company or a starting a partnership. An association of persons who take a personal interest in the firm and have mutual confidence and trust in one another can easily fund and manage the business through a partnership, which is an ideal structure for small-scale enterprises. However, incorporation is the sole option when the enterprise requires a larger mobilisation of cash that cannot be provided by the resources of a few people. It is important to note that even for a small – scale business, incorporating a company would be the right option as incorporation provides the advantage of limiting personal liability of the members of the company thereby limiting the risk of loss only to the extent of their shareholding or the amount guaranteed by the members.

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A fundamentally essential consequence of incorporation from which all the other implications flow, is that a company has a distinctive corporate personality which means that it is a "legal entity" distinct from the members of the company. As a result, a company can enjoy the rights and can be subjected to the duties which are different from the rights and duties enjoyed or incurred by its members. Even the courts did not fully appreciate the implications of a distinct corporate identity until the historic case of *Salomon v Salomon & Co Ltd*.[2]. The decision rendered in the instant case, which has been stated to be the "unyielding rock on which company law is constructed"[3], merits further attention.

Salomon was a leather merchant and had run a successful business for many years. Later on, in 1892, Salomon thought of transforming his business into a limited company. Ultimately, Salomon & Co. Ltd. was incorporated in accordance with then applicable legislations relating to formation of company. The members of the company were Salomon, his wife and five of his children. Salomon was the managing director of the company. The company paid a total of £39,000 as a consideration for purchasing Salomon's business, "*a sum which represented the sanguine expectations of a fond owner rather than anything that can be called a business like or reasonable estimate of value*"[4]. The company so incorporated paid the price for purchasing the business by issuing £10,000 in debentures, £20,000 in fully paid £1 shares; and the balance was paid in cash. The result was that out of 20,007 shares of the company issued, Salomon held 20,001. The remaining six shares were held by members of his family, supposedly as a nominee of Salomon who was in essence the absolute master by virtue of his shareholding in the company[5]. Within no time the company faced severe difficulties and after one year from the time of incorporation a receiver was appointed by the then debenture holders of the company. In simple words, the company went into liquidation. The assets of the company were adequate to dispense with the debentures. However, the claims of the unsecured creditors could not be honoured.

Taking into consideration the above – mentioned circumstances, it was held by the Court of Appeal that the entire transaction pertaining to incorporation was contrary to the true intent of the legislation relating to companies in force at that time. This was because the company, in essence, was a trustee or nominee for Salomon, who was the true owner and absolute master of the business. As a result, Salomon was personally liable to settle the unpaid debts. The House of Lords, however, unanimously reversed the verdict rendered by the Court of Appeal on the

[2] Salomon v Salomon & Co Ltd, A.C. 22, 51 (1897)
[3] Prest v Petrodel Resources Ltd, 2 A.C. 415, 66, (2013) (Lord Neuberge)
[4] Salomon v Salomon & Co Ltd, A.C. 22, 49, (1897) (Lord Macnaghten)
[5] Gower, Principles of Modern Company Law 2 – 002 (11th Edn 2021)

ground that the company had been incorporated validly, as the legislation only required the existence of seven members who shall hold at least one share. It was not mentioned in the legislation that the shareholders should be independent in the sense of making their own decisions uninfluenced by any other member of the company. Therefore, the liability to pay off the debts should be of the company and not the Salomon. In the blunt words of Lord Halsbury LC[6]:

"*Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not*."

Alternatively, as Lord Macnaghten put the matter[7]:

"*The company is at law a different person altogether from its subscribers.....; and, though it may be that after incorporation the business is precisely the same as it was before, and 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*."

The decision rendered in the instant case opened up new avenues for corporate lawyers all around the globe. Furthermore, the legality of a "one - person" company was established by this decision. It further made it clear that an investor cannot only limit his liability to the extent of the money invested in the company but also avoid any serious risk in respect of that investment by subscribing for secured debentures instead of shares. This is simply because in the event of liquidation, voluntary or otherwise, the debts of the secured creditors are discharged first and the shareholders are the last ones to be paid. Even before the Salomon case, India embraced the principle of Separate Legal Entity. The case of *Kondoli Tea Co. Ltd., re*[8], is the first authority on the matter. In this case, a tea estate was transferred by certain persons to a company. The persons claim ad valorem duty exemptions by virtue of the fact that the persons who owned the tea estate were the same as the persons who incorporated the company. Therefore, in essence, the transfer of the tea estate was being effected by such persons to themselves in the name of the company which according to them is the same thing. The court rejected the above – stated argument and held that: "*the company was a separate person, a separate body altogether from the shareholders and the transfer was as much a conveyance, a transfer of property, as if the*

[6] Salomon v Salomon & Co Ltd, A.C. 22, 31, (1897)
[7] Salomon v Salomon & Co Ltd, A.C. 22, 51, (1897)
[8] Kondoli Tea Co Ltd, re, Cal 43, (1886)

shareholders had been totally different persons.”[9]

Whilst a shareholder undoubtedly has a bundle of valuable rights in the company, including, inter alia, the right to cast a vote at the general meeting, he has no equitable or legal interest in the assets of the corporate entity. Moreover, it is not necessary that the principle of separate legal entity will necessarily work to the advantage of the shareholders. It can very well lead to unfair consequences. Both the points can be substantiated by *Macaura v Northern Assurance Co. Ltd*[10]. In this case, Mr. Macaura held almost all the shares of the company, except one. Moreover, he was the substantial creditor of the company. In his own name, he insured the company’s timber. When the timber was destroyed by fire, Mr. Macura proceeded to claim the insurance money but the insurance company refused to pay the same. The court held that the insurance company was not liable to satisfy the insurance claims of Mr. Macaura. This is because of the fact that the company is a separate entity from its members and thus, the property of the company solely belongs to the company. Shareholders cannot have any claim over the assets of the company. In simple words, they have no insurable interest in the assets of the company. As a result, Mr. Macaura could not succeed. He was bound by the consequences of separate legal entity that acted to his detriment.

In *Lee v Lee’s Air Farming Ltd.*[11], a company was incorporated by Mr. Lee of which he was the managing director. He appointed himself, in the capacity of the managing director, as the pilot of the company. Mr. Lee died in the course of employment. His widow was successful in recovering compensation under the Workmen’s Compensation Act as insurance was claimed by Mrs. Lee in respect of Mr. Lee’s capacity as a pilot of the company. Therefore, in this case Mr. Lee was equivalent to any other employee of the company and compensation was accordingly was awarded as it would have been awarded in case death of any other employee in the course of his employment. “In effect the magic of corporate personality enabled him to be master and servant at the same time”[12].

Now, there are certain consequences which flows from the principle of separate legal entity. Most important being Limited Liability. However, it is pertinent to point out that incorporating a company with limited liability is always a choice. When the promoters choose to incorporate a company with limited liability, the liability of the members is limited only to the extent of money invested by them or the amount guaranteed by them. In contrast, in case of partnership

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[9] Avtar Singh, Company Law 7 (17th Edn 2018)
[10] Macaura v Northern Assurance Co. Ltd, A.C. 619 (HL), (1925)
[11] Lee v Lee’s Air Farming Ltd, 3 WLR 758 (PC), (1960)
[12] Gower, Principles of Modern Company Law 202 (3rd Edn 1969)

the liability of partners is unlimited. A partner's entire fortune is at jeopardy, as creditors might impose execution even on his personal possessions.

Another consequence flowing from the principle of separate legal entity has already been highlighted above in the *Macaura* case. A company, being a legal person, has the potential to own, hold, enjoy and dispose of the property in its own name. The company's property is not the shareholders' property; it is solely the company's property. Thus, incorporation facilitates the distinction between company's property from that of its members. Thus, the creditors of the company will settle the claims only against the assets of the company and not the personal assets of the shareholders. Similarly, the creditors of the shareholders will satisfy their claims only against the personal assets of the shareholders and not the assets of the company.

Just like a natural person, a company can sue as well as be sued in its own name. A company can file a criminal complaint but the same is necessary to be represented by a human being as the company being an artificial person does not have arms, legs or brain of its own and thus, cannot file a complaint all by itself. A company's complaint is subject to dismissal in a similar manner as an individual's complaint is subject to dismissal due to the complainant's absence. A company has a right to claim damages if any person or corporation tries to tarnish its good name or if any libel or slander about the company damages its business.

Unlike a natural person, a company, being an artificial person, is not susceptible to “the thousand natural shocks that flesh is heir to” as a company cannot be deprived of its capacity by illness and it does not have a fixed span of life. Now this does not imply that the death or incapacity of natural persons in the company would not generate significant problems. For instance, if all the directors of the company die in a plane crash, it would definitely be an inconvenient situation for the company but the company will not stop existing. It is true even for a One Person Company (OPC). However, in case of a OPC a nominee has to be appointed.

Another crucial consequence flowing from the concept of separate legal entity is easy transferability of shares. Nowadays shares can be held not only in physical form but also in dematerialized form. Holding shares in dematerialized form is advantageous to the shareholders as it enhances the liquidity and is easier to encash. Moreover, Section 44 of the Companies Act, 2013 states that: “the shares or debentures or other interest of any member in a company shall be movable property, transferable in the manner provided by the articles of the company”. In contrast, in a partnership, a partner cannot transfer his portion of the firm's capital without the unanimous permission of all the partners.

Another important aspect of incorporation is that a structure is put in place which facilitates the

pursuit of larger and riskier ventures by permitting large number of investors to participate by purchasing shares of the company, whilst separating the investment function from a more complex task pertaining to management function of the company, which is assigned to a small group of individuals who have expertise in the field of management. The separation of "ownership" from its "control" or "management" is a characteristic feature of huge corporations. However, it is pertinent to point out that "owners" and "managers" are often the same when it comes to small companies and thus, separation of ownership from management does not constitute a distinguishable feature when it comes small companies.

Furthermore, because of their personal liability, it may appear that a solo trader or partners in a partnership firm can easily borrow funds from external lenders. However, in reality this is not always the case. Since the company can hold property of its own therefore, it can take loan in its own name. The company can provide its assets as a security to the creditors for the loan taken by the company. The creditors have assurance that in the event of non – payment, the debts can be recovered from the secured assets of the company thereby facilitating easier access to credit. Also, since the company is a separate entity from its shareholders, it has to pay taxes for the profits made by it. The shareholders, on the other hand, will be liable to pay taxes only on the personal gains made by them by virtue of being the shareholder of the company.

II. DISADVANTAGES OF INCORPORATION

The benefits of incorporation listed above are not inconsiderable and the downsides are minor in comparison. However, some of them, which are essentially complications emerging from the concept of limited liability, demands attention. A major disadvantage in the present context is lifting the corporate veil. At this point, it is important to state that the rule is always separate legal entity, its exception is corporate veil lifting. It simply means to look beyond the legal person. It means to look at the natural persons who are responsible for controlling the corporate entity. However, it is necessary to stress the fact that veil lifting is only an exception and the same has to be avoided unless the circumstances warrant otherwise.

As far as statutory veil lifting is concerned, reference can be made to section 464 of the Companies Act, 2013. The intention behind incorporating such provision is "to revoke the benefits of incorporation if the conditions of incorporation are not maintained". For instance, the companies are required to maintain certain numerical strength as to the number of shareholders in the company or say the company does not pay the requisite fees, when required. In such circumstances, because the company failed to comply with the terms of incorporation, the benefits of incorporation would be withdrawn.

Secondly, if a company's name is wrongly described or is properly mentioned in any act or contract, as required by section 12 of the Companies Act, 2013, individuals who are genuinely involved in such act or have entered into the contract are personally accountable for it. In *Hendon v Adelman*,[13] personal liability of the directors was attracted as they wrote a cheque in the name of a company wherein the name of the company was stated to be "L R Agencies Ltd," when the actual name of the company was "L & R Agencies Ltd."

Thirdly, section 339 of the Companies Act of 2013, which sanctions liability on account of fraudulent conduct of a company's business, can be mentioned. This provision states that "if in the course of winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other persons, or for any fraudulent purpose, those who were knowingly parties to such conduct of business may, in the discretion of the Tribunal, be made personally liable for all or any of the debts of the company". The key thing to keep in mind here is that this provision cannot apply at all times. It applies only at the time when the company is being wound up. This provision has been incorporated to protect the creditors of the company or to avoid instances of tax evasion.

Another downside of incorporation is the necessity to comply with the formalities, and bear the costs at the time of incorporation, at all times when the company is a going concern and also at the time of its final dissolution. This ensures a greater degree of transparency for companies which is not required sole traders or partnerships. A partnership, on the other hand, arises out of the mere existence of a relationship between the partners where a business is carried on by all of them with the object of making profit and an informal arrangement between the partners suffices, although it would be commercially prudent to record the partnership agreement in writing.

III. Conclusion

Since the company is an artificial person and does not have hands, legs and brain of its own, it is managed by natural persons. There is no doubt that one should opt for incorporation owing to the fact that it limits the personal liability of the investors to the extent of their shareholding or the amount guaranteed. This enhances the confidence of the investors by reducing the risk of loss. By now we know that with incorporation comes the principle of separate legal entity. Although the said principle brings with it, bagful of advantages but after taking into consideration the instances where the corporate veil can be lifted, it is crystal clear that personal liability is not eliminated by virtue of incorporation at all times and in all circumstances. In

[13] Hendon v Adelman, 637 New LJ, (1973)

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exceptional circumstances the veil can be lifted and when the veil is lifted the principle of separate legal entity no more applies and the company is same as its members.

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