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Commercial Applications of Company Law

THE LEGAL NATURE OF COMPANIES

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THE LEGAL NATURE OF COMPANIES

[¶301] Introduction

Chapter 1 looked at the commercial or functional nature of companies, and introduced in general terms the structure of companies. This chapter develops that discussion further, by looking at the legal nature of companies.

Companies have two particularly significant legal characteristics or attributes that make them able to undertake activities in their own right. They have:

- separate legal personality, and
- legal capacity.

These characteristics, and their implications, are discussed below. The third important legal characteristic of companies limited by shares is that the law provides shareholders of such companies with limited liability. Limited liability is discussed in the second part of this chapter.

SEPARATE LEGAL PERSONALITY

[¶302] What is "separate legal personality"?

The law treats a company as being a separate person from its shareholders and those who manage its operations. This is the doctrine of **separate legal personality** .

The central distinguishing characteristic of a company is that it is treated as a separate person from its participants. This means that the company can incur and receive obligations and hold property in its own name. For example, a company can lend or borrow money, enter into contracts with its participants and with outsiders such as suppliers and customers, be the registered proprietor of land and own chattels (personal property), be a lessee or lessor, operate a bank account and take out insurance, and act as trustee of a trust in its own right. The company can be the plaintiff or the defendant in civil proceedings, and in certain cases may be the defendant in criminal prosecutions. The rights it holds and the obligations it incurs are the company's own, not those of its managers, the people who have invested in it, or its employees.

One judge has described the doctrine of separate legal personality in the following terms:

> "Between the investor, who participates as a shareholder, and the undertaking carried on, the law imposes another person, real though artificial, the company itself, and the business carried on is the business of the company, and the capital it employs is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is a mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspects of the facts."
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> 1 *Gas Lighting Improvement Co Ltd* v *IR Commrs* [1923] AC 723 at pp 740–741, per Sumner LJ.

The legal rules that separate the company from its participants are referred to by lawyers as the "corporate veil".

The fact that the company is treated as a separate person from its participants means that the company continues unchanged even if the identity of the participants in it changes. It also means that the company can enter into legal relationships with its participants, for example as debtor and creditor or as employee and employer. If the company and its participants were not separate legal persons, these relationships would not be possible.

In addition, companies are generally treated as separate entities liable for income tax under the *Income Tax Act 2007*.

[¶303] The general rule: Salomon's case

The fact that a company was a legal entity separate from its participants was affirmed over 100 years ago in the leading case of *Salomon* v *Salomon & Co Ltd*.

2 [1897] AC 22. For an extended discussion of this case, see J Farrar, "Corporate Personality" in J Farrar (gen ed), *Company and Securities Law in New Zealand* (2008), para 5.2.

What are the facts in Salomon's case?

Mr Salomon ran a boot manufacturing business as a sole trader. After the business was established, Mr Salomon incorporated a company in which he and members of his family were the only shareholders, and he sold the business to the company. The company paid Mr Salomon part of the purchase price for the business immediately (in the form of shares in the capital of the company), and agreed to pay the remainder over time. To secure its obligation to pay, the company gave Mr Salomon security over its assets in the form of a company charge.

3 Company charges are explained in Chapter 20.

The effect of the charge was that the company's assets had to be used to pay out Mr Salomon in full before they could be applied to pay out the company's other, unsecured creditors.

Mr Salomon controlled the company, by holding almost all the shares in the company and also through his appointment as its managing director and through an agreement with the members of his family that they would exercise their rights to participate in the management of the company in accordance with his directions.

What was the legal issue in Salomon's case?

When the company's business failed, the value of the assets was insufficient to pay out both Mr Salomon and the company's other creditors. The creditors argued that Mr Salomon should not receive the benefit of the charge (giving him the right to be paid in priority to them), because the degree of control he exercised over the company meant it should be treated as being his agent, or trustee for him, in the conduct of the business. If the company were Mr Salomon's agent, or were operating the business as trustee for him, he would have been required to indemnify the company for the debts it had incurred.

What did the court decide?

The case is significant because the House of Lords held that, despite the fact that Mr Salomon controlled the company, it was not his agent or trustee. The company was treated as operating the business in its own right, and as being separate from its controller, Mr Salomon. Therefore, the charge given by the company to Mr Salomon was valid and he was entitled to be paid his debt even though other creditors of the company would not be paid because the company had insufficient assets to pay all its creditors.

The fact that a company is a separate entity from its controllers has also been emphasised in the context of corporate groups

4 Corporate groups are discussed in Chapter 5.

by the courts.

5 *Savill* v *Chase Holdings (Wellington) Ltd* (1989) 4 NZCLC 64,908 (PC), *Savill* v *Chase Holdings (Wellington) Ltd*; *Savill* v *Concept Investments Ltd (No 2)* (1988) 4 NZCLC 64,628 (CA), *Savill* v *Chase Holdings (Wellington) Ltd* (1988) 4 NZCLC 64,574 (CA), *Savill* v *Chase Holdings (Wellington) Ltd*; *Concept Investments Ltd* v *Savill* (1988) 4 NZCLC 64,442, *Savill* v *Chase Holdings (Wellington) Ltd* [1989] 1 NZLR 257 (PC, CA and HC), *Industrial Equity Ltd* v *Blackburn* (1977–1978) CLC ¶40-370; (1977) 137 CLR 567.

[¶304] What are the consequences of treating the company as a separate legal entity?

The consequences of treating the company as a separate person from its participants include the following.

A company's obligations and liabilities are its own, and not those of its participants :

Where a company incurs a contractual obligation or a liability in tort, that obligation or liability is the company's and not an obligation or liability of its shareholders or officers. Because companies are separate entities, creditors of a company are generally unable to look to the participants in the company to pay the company's debts.

6 There are statutory exceptions to this general rule. For example, creditors may be able to recover money owed to them by a company from the company's directors in certain circumstances. See s 301 of the *Companies Act 1993*.

A company can sue and be sued in its own name : Section 15 of the *Companies Act 1993* provides that, when a company is registered, it "is a legal entity in its own right". As such, from that time it can sue or be sued in its own name. This means that it is not necessary for the shareholders of the company or its officers to be named as parties to the legal proceedings where the proceedings involve only the company.

A company has perpetual succession : This means that the company is a continuing entity in law with its own identity, regardless of changes in its membership. It continues in existence, unchanged, even if its original shareholders die, sell their shares to others, or otherwise cease to participate as shareholders. The company continues in existence until it is deregistered under the statutory procedure set out in the Companies Act.

A company's property is not the property of its participants : Unlike the beneficiaries of a trust, the participants in a company have no proprietary (legal or equitable) interest in the company's property. They therefore have no "ownership" rights in respect of it. For example, in *Macaura* v *Northern Assurance Co Ltd*,

7 [1925] AC 619.

Mr Macaura transferred his interest in a timber plantation to a company controlled by him. He had insured the timber in his own name but had failed to transfer the insurance policy to the company. When the timber was destroyed by fire, the insurance company refused to pay out under his policy because he did not have an "insurable interest" in the timber as he was not its owner. The company was the owner of the timber.

A company can contract with its controlling participants : Because they are separate legal entities, a company and its participants can enter into contracts with each other. For example, we have seen from *Salomon*'s case that a company can lend money to or borrow money from its controlling shareholder. In *Lee* v *Lee's Air Farming Ltd*,

8 [1961] AC 12.

the controlling shareholder and managing director of a company that operated a business which involved aerial top-dressing of farm land was killed in a flying accident. His widow successfully argued that she was entitled to a pay-out under worker's compensation insurance for her husband's death because her husband was a "worker", that is, that he had entered into a contract of service with the company. Unless the company and its controller were separate legal entities, the finding that a contract existed between them would not be open to the court, because a contract requires at least two separate parties.

THE EXCEPTIONS: PIERCING THE CORPORATE VEIL

[¶305] Introduction

Despite the general rule established by *Salomon*'s case that a company and its participants must be treated as separate legal entities, courts are sometimes asked to "lift the corporate veil" and ignore the separate personality of the company.

This request may come from a creditor of the company, who wants a participant such as a major shareholder or director to be held liable for the company's debt. *Salomon*'s case was an example of such a claim by creditors, even though they did not succeed. Or the request may come from the participants in the company itself; for example, because they are seeking to establish some legal interest in the company's property, as was the case in Macaura, where again the claim was unsuccessful.

However, in some cases the courts have been prepared to pierce the corporate veil and treat the company and one or more of its participants effectively as the same person. Incorporation does not fully "cast a veil over the personality of a limited company through which the courts cannot see",

9 *Littlewoods Mail Order Stores Ltd* v *McGregor* [1969] 3 All ER 855, per Denning MR.

and in some circumstances it will be appropriate for the court to look through the veil of incorporation to discover the identity of the participants in the company and impose liability on them.

Further inroads have been made to the doctrine of separate legal personality by provisions of the *Companies Act 1993* itself, imposing liability for an insolvent company's debts on certain of its participants in some circumstances.

[¶306] The corporate veil and tort claimants

A person who is injured by another may be entitled to recover damages or compensation for his or her injury, if the facts establish a valid legal claim under tort law (for example, the law of negligence). What happens where the defendant in such a claim is a company, and the court orders that the company pay damages or some other form of compensation that exceeds the value of the company's assets?

We saw at ¶304 that one of the consequences of a company's separate legal personality is that its debts (including judgment debts) are its own and not those of its participants. The shareholders or managers of a company will not be required to make up the difference between the company's assets and the amount of the debt, unless the court is prepared to depart from the general rule and pierce the corporate veil in one of the ways described below.

The effect of the separate legal personality of companies on tort claimants is illustrated by the case of *Trevor Ivory Ltd* v *Anderson*.

10 (1992) 6 NZCLC 67,611; [1992] 2 NZLR 517 (CA).

> Trevor Ivory operated what could be described as a "one-person" company. He was the managing director, substantial shareholder and employee of the company. The company was a supplier of sprays and horticultural advice. Mr Ivory advised a client of his company to use a herbicide to control weeds which were growing in a crop of raspberries. The herbicide, when applied in accordance with this advice, not only destroyed the weeds, but it also caused considerable damage to the raspberry crop. The client brought an action in tort and contract against the company as well as Ivory in his personal capacity. In the High Court, the company was held liable in contract and tort, and Ivory was held liable in tort. Ivory appealed to the Court of Appeal. That court found that Ivory was not personally liable because he had made it clear in his dealings with his clients that he intended limited liability. Ivory was acting on behalf of the company — indeed he was the controller of the company, so the company could be held liable. In the Court of Appeal, McGechan J pointed out that he did "not accept a company director of a one-man company is to be regarded as automatically accepting tort responsibility for advice given on behalf of the company by himself". However, if it can be shown that there is a clear indication that a consultant or adviser intends to make "a personal commitment as opposed to the known company responsibility",
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> 11 Ibid, at NZCLC p 67,628; NZLR p 532.
>
> personal liability may result.

[¶307] In what circumstances have courts pierced the corporate veil?

In exceptional circumstances, courts may pierce the corporate veil and disregard the separate legal personality of the company. This may occur:

- at common law, where the corporate form is being used to avoid an existing legal duty, where the company is acting as the agent or partner of its controller, or where a particular law shows an intention that the corporate veil should be disregarded in applying it, or

• under statute.

12 For example, s 25(2), 134 and 135 of the *Companies Act 1993*.

It is important to remember that these circumstances represent exceptions to the general rule that each company must be treated as a separate legal person. In particular, the courts often note that people cannot choose to use the corporate form when it suits them, then later ask the courts to disregard the legal effect of that form:

> "If people choose to conduct their affairs through the medium of corporations they are taking advantage of the fact that in law those corporations are separate legal entities, whose property and actions are in law not the property or actions of their incorporators or controlling shareholders. In my judgment controlling shareholders cannot, for all purposes beneficial to them, insist on the separate identity of such corporations but then be heard to say the contrary when [it is no longer in their interest]."

13 *Tate Access Floors Inc* v *Boswell* [1991] Ch 512 at p 531, per Browne-Wilkinson VC.

In New Zealand, there appears to be a judicial presumption in favour of recognising companies as distinct legal entities. In *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) at pp 158–159, Richardson J stated:

> "[T]he starting point must be that the importance of the doctrine laid down in *Salomon* v *Salomon & Co Ltd* was re-emphasised by the Privy Council in *Lee* v *Lee's Air Farming* … [A]ny suggested departure from the doctrine laid down in *Salomon* v *Salomon & Co Ltd* should be watched very carefully."

[¶308] When have courts pierced the corporate veil at common law?

On occasions courts have been prepared to lift the corporate veil, but "the doctrine of lifting the corporate veil spans an extremely broad area and it is probably impossible to find an explanation for all the decisions which have hinged on it".

14 A Beck, "The Two Sides of the Corporate Veil", in J Farrar (ed), *Contemporary Issues in Company Law* (1987), at p 91. See also J Farrar, "Corporate Personality" in J Farrar (gen ed), *Company and Securities Law in New Zealand* (2008), para 5.3.

However, it may be possible to group the decided cases under the following headings.

Where the corporate form is used to avoid an existing legal duty

It is usual and appropriate for persons intending to carry on business to form a company for the purpose of limiting their personal liability for obligations or liabilities incurred in the future by the company in carrying on that business. This is one of the key rationales for using a limited liability company to carry on a business.

If a company is formed "for the sole purpose of or for the dominant purpose of" doing something that one of the participants is prevented from doing in a personal capacity through an existing legal obligation, the courts may pierce the corporate veil to treat the obligation that binds the participant as one that also binds the company.

Cases cited in support of the proposition that the courts will pierce the corporate veil to treat obligations imposed on participants in a company as binding on the company in circumstances where the company has been used to avoid that duty include *Gilford Motor Co Ltd* v *Horne* and *Jones* v *Lipman*. However, neither case is particularly strong authority and alternative grounds for the finding of the court in each case can be put forward.

15 HAJ Ford, RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (13th ed, 2007), para 4.250.

In *Gilford Motor Co Ltd* v *Horne*,

16 [1933] Ch 935.

Mr Horne had been employed as managing director of Gilford Motor. In his employment contract, he had agreed to a "non-compete" clause, the purpose of which was to prevent him from leaving Gilford Motor and setting up in opposition to it. Under the contract, he was subject to a contractual agreement not to solicit customers of Gilford Motor. After he resigned as managing director of Gilford Motor, he set up a business in competition to it. The evidence showed that Mr Gilford was concerned that, in doing so, he might be in breach of his contract not to solicit Gilford's customers. A company was established to conduct the new business, in which the only shareholders were Mr Horne's wife and one of his business associates. The company conducted the rival business and Mr Horne ran the company.

Gilford Motor argued that the court should pierce the corporate veil to recognise that the person behind the new company was Mr Horne, and to treat the company, along with Mr Horne, as being bound by the non-compete clause in the contract. The court found, in this case, that the company had been formed for the sole or dominant purpose of avoiding the non-compete clause. It was prepared to treat the company, along with Mr Horne, as being bound by it.

In *Jones* v *Lipman*,

17 [1962] 1 WLR 832.

Mr Lipman entered into a contract to sell land to the plaintiffs. Before the sale was completed, Mr Lipman transferred the land to a company controlled by him. The intention was to put the land beyond the reach of the purchasers: while they would be entitled to sue Mr Lipman for damages for failure to transfer the land to them, they would not be able to compel him to do so because the land had been transferred to a third party — the company. In this case, the court pierced the corporate veil and treated the contractual obligation on Mr Lipman to transfer the land as also binding on the company. This was because the court took the view that the company had been used by Mr Lipman as a device to avoid his existing contractual obligations.

Where the company is acting as the agent or partner of the controller

Because they are separate legal persons, it is possible for a company to be the agent or partner of its controller. However, this depends on establishing particular facts. We saw in *Salomon*'s case that the fact that a person controls a company is not sufficient to make the company an agent of the person.

If a person incurs an obligation or holds a right as agent for another person (called the **principal**), then the right or obligation belongs to the principal. Therefore, if a company were treated as the agent of a person who controlled it, any rights or obligations of the company arising under the scope of the agency would be treated as rights or obligations of the controller. This would have the effect of piercing the corporate veil.

Recent Australian research on cases where it has been argued that the corporate veil should be pierced suggests that the existence of an agency relationship between a company and its controller (most often, a parent company) is the ground most frequently argued before the courts.

18 I Ramsay and G Stapledon, "Corporate Groups in Australia" (2001) 29 *Australian Business Law Review*, p 7.

In some very limited circumstances, English courts have been prepared to treat the company as the agent or partner of its controllers, where the company was clearly under-resourced to carry on the activities for which it was formed and did not operate independently in any way from its controllers. For example, in *Smith, Stone & Knight Ltd* v *Birmingham Corporation*,

19 [1939] 4 All ER 116.

a company (the **parent company**) that controlled another company (its **subsidiary**) argued successfully that the subsidiary should be treated as carrying on its business as agent for the parent company, entitling the parent company to receive compensation for disruption to its business when the premises on which the business was conducted were compulsorily acquired by the local council.

20 The concepts of “parent company” and “subsidiary” are discussed in Chapter 5.

A review of the relevant case law has suggested that such a finding is more likely where the controller is a company, rather than a natural person.

21 I Ramsay and G Stapledon, op cit.

The basis on which a subsidiary may be treated as an agent of the parent has been summarised in the following terms:

> “Where a parent company withholds from the subsidiary the normal consequences of being a separate legal entity, there is a possibility that the courts will identify it with the controller. This may happen where a parent company forms or acquires a subsidiary ostensibly to do something for which the subsidiary needs a minimum of resources but the parent does not give it adequate proprietors’ capital or loan money, or equip it to run its own business by loan of personnel or other resources, or give it a reasonable chance of independently obtaining credit or resources from third persons. In such a case, a court may hold that the dominated subsidiary is an agent of the parent or a partner with it.”
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> 22 Ford, Austin and Ramsay, op cit, para 4.370.

Where the law shows an intention that the corporate veil be disregarded

In some cases, courts have found that a particular legal rule should be interpreted as requiring them to ignore the corporate veil.

For example, during the First World War, legislation was passed in Britain preventing people from trading with the enemy. To give effect to that legislation, an English court was prepared to look through a company incorporated in Great Britain to discover the nationality of its controllers.

23 *Daimler Co* v *Continental Tyre and Rubber Co (Great Britain) Ltd* [1916] 2 AC 307.

Such an approach is based on some clearly discernible policy underlying a particular law (in this case, the law preventing trading with the enemy), rather than on general principles of company law.

The corporate veil is also lifted in some statutes (for example, under income tax legislation and under the *Companies Act 1993* itself).

CORPORATE CAPACITY

[¶309] What do we mean by “corporate capacity”?

In the previous section, we examined the principle of company law that a company is separate from its participants. In this section, we examine more closely the principle that a company is a **legal person** — an entity that, although artificial, is recognised by the law as being capable of acting in a manner that has legal effect.

A company’s ability to do acts of legal effect is referred to as its **capacity** .

24 See S Watson, “Capacity of the Company” in J Farrar (gen ed), *Company and Securities Law in New Zealand* (2008) Chapter 7.

Companies have the legal ability to do most things that a natural person can do, and some additional things. Their capacity is conferred by s 16 of the *Companies Act 1993*, which is discussed below. A company’s constitution may include internal limitations on its permitted activities, but these do not affect the validity of its acts.

[¶310] The capacity of a company

We will see in this section that companies have the legal capacity to do most of the things that a natural person can do, and some additional things (such as issue shares) that they need to do because they are companies.

Companies are, of course, an abstraction. They do not have any physical identity and are incapable of "doing" acts in a physical sense. For example, a company does not have a hand with which it can sign a contract. Companies must act through natural persons, such as their officers or shareholders.

We will see in Chapter 7 that companies can act directly through one of the organs of the company (the board of directors or the shareholders in general meeting) acting within the scope of their respective powers. Companies can also act indirectly through their agents, appointed under the principles of agency law.

In this chapter, we are concerned with the extent of the company's corporate power — its legal capacity — to do a particular act or thing. There is also an extensive body of company law that is concerned with the authority of individuals (such as its officers and agents) to exercise that corporate power. The authority of individuals to exercise corporate power is discussed in Chapters 21 and 22.

[¶311] How wide are the powers of companies?

When a new company is created by registration, the *Companies Act 1993* confers on that company the power to do acts that have legal effect. In many respects, the capacity of a company to do acts having legal effect is the same as that of a natural person.

We have seen that companies are treated by the law as separate legal persons. Section 16 of the Companies Act gives a company the legal capacity and powers of a natural person. This means that a company can do anything that a natural person can do, such as enter into contracts and hold property, although the company's capacity does not extend to things that, by their nature as artificial persons, companies are unable to do, such as marry or appear in person (that is, without a legal representative) before a court.

25 See *Simto Resources Ltd* v *Normandy Capital Ltd* (1993) 11 ACLC 856; 10 ACSR 776.

In addition, companies have certain powers that natural persons do not have, such as the power to issue shares.

[¶312] What is the effect of any internal limitations on powers?

The fact that a company has such wide powers may not suit all of its participants. For example, the shareholders of a company may wish to restrict the company's activities to particular, previously agreed objects. To this end, participants in companies may agree between themselves that the company will limit its activities in certain ways.

By including such restrictions in the company's constitution, those restrictions will bind not only those who agree to them at the time, but also the company and any person who becomes a shareholder or officer of the company at a later time.

26 This is because a company's constitution is binding on all its participants, under s 31(2). The constitution is discussed in detail in Chapter 6.

Such restrictions are envisaged by s 16(2) of the *Companies Act 1993*, which provides that "[t]he constitution of a company may contain a provision relating to the capacity, rights, powers, or privileges of the company only if the provision restricts the capacity of the company or those rights, powers, and privileges".

In the case where a company does have provisions in its constitution restricting or prohibiting the exercise of any of its powers, what is the effect of an act by the company that is outside the scope of those restrictions?

Section 17(1) states that "[n]o act of a company and no transfer of property to or by a company is invalid merely because the company did not have the capacity, the right, or the power to do the act or to transfer or take a transfer of that property". The intention of these provisions is to abolish the doctrine of ultra vires as it applies to companies, so that third parties that deal with companies can enforce obligations incurred by companies, even where those obligations were incurred in breach of these internal restrictions.

27 It should be noted that s 17(1) states that the exercise of a power or act of a company is not invalid merely because it is outside the restrictions imposed by the constitution. This suggests that other conduct of a person dealing with a company may affect the validity of the act. In particular, if a person dealing with a company was aware that the act was inconsistent with the restrictions contained in the constitution, any contract may be voidable as against that person at the option of the company. See s 18.

However, there can be consequences resulting from acts which are outside restrictions in the company's constitution. Such acts may amount to a breach of the statutory contract represented by the company's constitution. The effect of breaches of a company's constitution is discussed in Chapter 6. Causing the company to do something inconsistent with these restrictions may also amount to a breach of duty or other wrongful conduct on the part of the person (such as a director) who caused the company to do the act, and consequences may attach for that breach. Directors' duties are discussed in Chapters 12–15.

LIMITED LIABILITY

[¶313] What is "limited liability"?

We noted above that the third important legal characteristic of limited liability companies is that the liability of the shareholders to contribute to the debts of the company is limited to the amount (if any) remaining unpaid on their shares. This is referred to as **limited liability** .

Limited liability means that shareholders of a limited liability company are usually not required to contribute amounts from their personal wealth, beyond the subscription price of their shares, to meet the debts of the company.

The liability of shareholders to contribute

In a limited liability company the initial shareholders of the company subscribe for **shares** that represent a claim against the company to which certain rights (such as control rights and distribution rights) attach. The nature of those rights depends on the terms of issue of the share, and different rights may attach to different classes of shares in a company. The nature of shares is discussed in Chapter 18. Shareholders who join the company after its initial registration may do so by subscribing for new shares in the company or by acquiring from another shareholder shares which have already been issued.

Subscription for shares involves the person who wishes to become a shareholder of the company paying an amount of money (referred to as the **issue price** or **subscription amount**) to the company in return for the share. The issue price is determined by the directors at the time they decide to issue the new share.

When a new share is issued by a company, the directors may require payment in full of the issue price, or may allow the shareholder to pay part of the issue price at the time of issue, and the remainder at some time in the future. A share issued on this latter basis is called a **partly paid share** .

What is the underlying principle?

The underlying principle of limited liability is that a shareholder who holds a share in the company is not required to contribute to the company to meet the debts of the company, beyond the amount initially subscribed, or agreed to be subscribed, for the share.

28 Section 97, *Companies Act 1993*.

Where a shareholder holds a fully paid share, that shareholder is not required merely because of that shareholding to contribute any further amount to the company to cover the company's debts in the event that the company's own assets are insufficient to do so. Where a shareholder holds a partly paid share, that shareholder is required to pay the balance of the issue price to the company when the company makes a **call** on the shareholder to do so.

Generally speaking, the amount contributed by shareholders by way of subscription for share capital is intended to remain in the company for the duration of its operations. Shareholders will be entitled to a return of their capital prior to the company's liquidation only in certain circumstances, described in Chapter 19. In particular, they will not be entitled to a return of capital where it results in insolvency. On the company's liquidation, shareholders can expect a return of their capital only if the company has sufficient assets to do so, once all its debts are discharged.

[¶314] What is the rationale for limited liability?

We saw in Chapter 1 that limited liability granted by statute is a relatively recent phenomenon in Anglo–New Zealand company law, dating only from the *Limited Liability Act 1855* (UK). The effect of limited liability is to transfer the risk of corporate failure from the investors in the venture carried on by the company to its creditors.

If a company fails, the investors' loss will be limited to the amount initially subscribed, or agreed to be subscribed, to the company. This may be as little as a few dollars. Creditors of the company may lose all or substantially all of the money owed to them. This is because, once the company's assets are exhausted, the principle of limited liability prevents the creditors from looking to any of the participants in the company to make up any shortfall.

So it is important to remember that limited liability is a privilege conferred by law on the shareholders of a limited liability company. Limited liability is said to do the following:

29 These reasons are drawn from F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (1991), pp 41–44.

- Encourage risk-taking and entrepreneurial behaviour, by enabling investors to quarantine their wealth from particularly risky undertakings.

- Decrease the need for shareholders to monitor the managers of companies in which they invest because the financial consequences of company failure are limited. Shareholders may have neither the incentive (particularly if they have only a small shareholding) nor the expertise to monitor the actions of managers. The potential costs of operating companies are reduced because limited liability makes shareholder diversification and passivity a more rational strategy.

- Provide incentives for managers to act efficiently and in the interests of shareholders by promoting the free transfer of shares. This argument has two parts to it. First, the free transfer of shares is promoted by limited liability because under this principle the wealth of other shareholders is irrelevant. If a principle of unlimited liability applied, the value of shares would be determined partly by the wealth of shareholders. In other words, the price at which an individual shareholder might purchase a share would be determined in part by the wealth of that shareholder which was now at risk because of unlimited liability. The second part of the argument (that limited liability provides managers with incentives to act efficiently and in the interests of shareholders) is derived from the fact that if a company is being managed inefficiently, shareholders can be expected to be selling their shares at a discount to the price which would exist if the company were being managed efficiently. This creates the possibility of a takeover of the company and the replacement of the incumbent management.

- Assist the efficient operation of the securities markets because, as was observed in the preceding point, the prices at which shares trade do not depend on an evaluation of the wealth of individual shareholders.

- Permit efficient diversification by shareholders, which in turn allows shareholders to reduce their individual risk. If a principle of unlimited liability applied and a shareholder could lose his or her entire wealth by reason of the failure of one company, shareholders would have an incentive to minimise the number of shares held in different companies and insist on a higher return from their investment because of the higher risk they face. Consequently, limited liability not only allows diversification but permits companies to raise capital at lower costs because of the reduced risk faced by shareholders.

- Facilitate optimal investment decisions by managers. As we have seen, limited liability provides incentives for shareholders to hold diversified portfolios. In these circumstances, managers should invest in projects with positive net present values, and can do so without exposing each shareholder to the loss of his or her personal wealth. However, if a principle of unlimited liability applies, managers may reject some investments with positive present values on the basis that the risk to shareholders is thereby reduced. "By definition this would be a social loss, because projects with a positive net present value are beneficial uses of capital."

30 Ibid, p 44.

These benefits come at a cost, however. Perhaps, knowing that their personal assets are protected from claims against a company, the natural persons who run a company may be less careful than they would otherwise be, for example in matters of public safety. Persons who did not voluntarily choose to deal with a company with few assets, such as those who are harmed by a negligent act of a company, may be deprived of compensation.

[¶315] Contractual agreements that circumvent limited liability

A shareholder of a limited company may agree separately with a creditor to assume responsibility for a company's debts in certain circumstances. This would be a matter of contract between the particular shareholder and the creditor.

Often, in the case of small companies, a major creditor such as a bank may ask the shareholders of the company to provide a guarantee to the bank of the amount lent to the company. A guarantee is a promise to pay another person's debt if the other person refuses or is unable to do so. In this example, the shareholders of the company would agree with the bank to pay the company's debt if the company was unable to do so from its own resources.

What is the effect of such an agreement?

The effect of such an agreement, in practice, is to negate the benefits of limited liability for the shareholders of the company in respect of the debt which is the subject of the agreement.

Of course, it is open to the shareholders of the company to refuse to enter into such an arrangement. However, if it is a condition of the loan, and the company is unable to secure finance elsewhere, the shareholders may find that they have little choice but to agree to this condition.

Similarly, cross-guarantees may also be requested by creditors of shareholder companies of a corporate group, under which each individual company is required to guarantee the debts of every other company in the group. The effect of such arrangements is to negate the benefits of limited liability within the group with respect to the obligations which are the subject of the guarantee.

Where shareholders of a company have entered into such arrangements, those arrangements do not invalidate the principle of limited liability. However, they do work to circumvent it in practice, by providing a creditor with an alternative means of recovery, under contract, that involves recourse to the company's shareholders who provided the guarantee.

These arrangements operate only under contract. Unless a particular creditor has specifically contracted with a shareholder of a company to obtain a guarantee, the shareholder will be able to rely on the principle of limited liability (except in the limited circumstances). Small creditors, and those who have a claim against the company arising otherwise than through contract (for example, a claim in tort), generally will not have such arrangements in place.