CHAPTER III

LEGAL PERSONALITY, CONSEQUENCES OF INCORPORATION AND PROMOTERS

1. Legal Personality, Consequence of Incorporation, Use and Misuse of Corporate Structure

LEGAL PERSONALITY AND CONSEQUENCES OF INCORPORATION

Introduction

[1]
Upon incorporation, a company is a legal person and is independent of and separate from its controlling members. The fact that its controlling members are in total and effective control of its affairs or that the company is to serve its members' interest is no excuse to disregard the concept of legal personality or to treat the company and its members as the same entity for some legal purposes or for some ensuing consequences.

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Legend of incorporation

General rule

[2]
Legal personality established through the process of incorporation cannot be ignored by the court. It is a layman's fallacy that incorporation is a machinery merely for effecting shareholders' purpose. In a useful and often quoted passage in *Gas Lighting Improvement Co Ltd v IRC* [1923] AC 723, Lord Sumner said at 740 that:

> 'It is said that all this was 'machinery', but this is true of all participations in limited liability companies. They and their operations are simply the machinery, in an economic sense, by which natural persons, who desire to limit their liability, participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership but, legally speaking, this machinery is not impersonal though it is inanimate. Between the investor, who participates as a shareholder, and the undertaking carried on, the law

interposes another person, real though artificial, the company itself, and the business carried on is the business of the company, and the capital employed 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 ... the idea that it is 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.'

This legal legend creates the following layman's perceived 'fallacies' but yet they are well-established legal principles.

Salomon's legend

[3]
In the case of *Salomon v Salomon & Co* [1897] AC 22, Mr Salomon converted his business into a company. In acquiring Salomon's business,the company created a debenture in favour of Mr Salomon to cover part of the purchase consideration. The debenture gave a floating charge on its assets as security. Seven shares of the company were issued to Mr Salomon and his family members as subscribers. The company went into liquidation subsequently and its assets were not sufficient to pay off the unsecured creditors. It was held that the company which had been properly formed was a legal person in its own right separate from Mr Salomon despite the fact that the company controlled by Mr Salomon created the debenture, thereby enhancing Mr Salomon's priority claims for the assets of the company upon its liquidation before the satisfaction of the claims of the company's creditors. In the speech of Lord Macnaghten, he stated at 51 that:

> 'The company is at law a different person altogether from the subscribers to the Memorandum and although it may be that after incorporation the business is precisely the same as it was before, and the 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 subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act. That is, I think, the declared intention of the enactment.'

[4]
The *Salomon* case demonstrates the reluctance of the court to attribute a company's liabilities to its members notwithstanding that rights of third parties (notably the creditors of a company) may be adversely affected.

Salomon's lesson

[5]–[50]
The lesson one may learn from *Salomon* case is that the concept of separate legal entity can be lawfully 'abused' to elevate what would otherwise be a deferred shareholder's claim for return on capital vis-à-vis the claims raised by the general creditors of the company. For example,

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assuming that one is going to set up a business and that the necessary initial working capital required to set up the intended business is HK$300,000. It is tempting for one to make use of the principle enunciated in the *Salomon* case to have minimum capitalisation, say HK$100, as paid-up capital and with the balance of the working capital met by way of shareholders' loan. The company's assets (both existing or to be acquired) and its business can then be covered by a floating charge executed by the company in favour of its founding members to secure repayment of the shareholders' loan. Should there be a corporate failure, whether or not due to mismanagement of the founding members, they can still enjoy a priority claim on the assets of the company over those of the company's general creditors. The liabilities which the founding members assumed are restricted to the capital that they subscribed or agreed to contribute, and in our case, the sum of HK$100. This is a seemingly unfair situation that the court cannot correct as it is legitimate for one to use a corporate structure to prevent any liability from occurring in the future and this is exactly the basis of the principle enunciated in the *Salomon* case.[1] The fact that what the court may have thought to be fair and just or that there is a perceived injustice is not a ground for the court to intervene.[2]

1 See also *China Ocean Shipping Co v Mitrans Shipping Co Ltd* [1995] 3 HKC 123.
2 See *Adams v Cape Industries Plc* [1990] 2 WLR 657.

Property ownership and accrued rights

Company property versus shareholding

[51]
Although members of a company own the company, the company's property is owned by the company, not by its members. A company does hold the property on trust for its members in the absence of an express trust created to that effect; this means that members cannot be regarded as the beneficial owners of the company's property. *The Maritime Trader* [1981] 2 Lloyd's Rep 153. Furthermore, shareholders are not, in the eyes of law, part owners of the undertaking which is something different from the totality of the shareholdings: *Short v Treasury Commissioners* [1948] 1 KB 116 per Evershed LJ at 122. In *JJ Harrison (Properties) Ltd v Harrison* [2002] 2 BCLC 162, the Court of Appeal held that a company is not a trustee of its own property. Instead, it is the legal and beneficial owner of that property which cannot be disposed of except in accordance with its memorandum and articles. On the other hand, a director, on being appointed to that office, assumes the duty of trustee of the company's property.

[52]
In *Richcombe Investment Ltd v Tin Fung* [2001] 2 HKC 115, the question before the court was, inter alia, whether a Mareva injunction should be granted upon application by the plaintiff against its directors in respect of

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their misappropriation of remittances when dealing with forex trading through the plaintiff's sub-subsidiary. Sakhrani J said at 118 that:

> 'It is trite law that a shareholder of a company has no rights over the assets of the company. His rights are to the shares of the company and not to the assets of the company. He owns the shares, not the assets. The assets belong to the company. This distinction is of fundamental importance and a matter of basic company law.'

Property interest and insurance interest

[53]
This principle is illustrated in *Macaura v Northern Assurance Co Ltd* [1925] AC 619 where it was held that the owner of a timber estate who sold all his timbers to a company in which he effectively owned all the shares had no insurable interest in the timbers in relation to a fire insurance taken out in his own name. The fact that the owner can derive profit, or suffer loss, from the timbers does not confer him any legal or equitable interest in the timbers. As succinctly put by Lord Wrenbury: '...the corporator even if he holds all the shares is not the corporation ... neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation'. Equally, a company has no insurable interest in the assets of the principal shareholder: *Wandlyn Motels Ltd v Commence General Insurance Co* (1970) 12 DLR (3d) 605.

[54]
In *Verderame v Commercial Union Assurance Co plc* [1992] BCLC 793, the plaintiffs who were only the shareholders of a company through insurance brokers arranged for an insurance policy covering losses from theft and business loss. Theft occurred in the company's premises resulting in a loss of business and income by the plaintiffs as shareholders. An action by the plaintiffs against the insurance brokers for negligence for failure to insure the company's property was not upheld as the right of action should accrue to the company.

Self-acquisition

[55]–[100]
The principle of separate legal personality was also upheld in *Acates & Hutcheson plc v Watson* [1995] 1 BCLC 218 in which a company (ie the acquirer) which acquired the controlling interest of another company (as its subsidiary) that only held the shares of the acquirer, was held not to have infringed the rules concerning the prohibition of a company acquiring its own shares.[1]

1 See section 58(1A).

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Property holding company

[101]
In *Good Profit Development Ltd v Leung Hoi* [1992] 2 HKC 539, it was held that an agreement entered into between the directors/shareholders of a company which owned a landed property and the purchaser for the sale and purchase of the landed property could not be specifically enforced as the company was not a party to the agreement and those who promised to convey the landed property did not own it. The argument of a trust was rejected and the invitation of the court to lift the corporate veil was turned down. According to Woo J at 545:

> 'the normal rule is that a company does not hold property as an agent or trustee for its members and a fortiori it does not hold property as agent or trustee for its directors … The incorporation or acquisition of a private limited company to hold a landed property purchased or to be purchased by the shareholders is nothing out of the ordinary, and if I may say so, a very common practice in Hong Kong. The mere fact that the shareholders in litigation have absolute control of the company which has no other business activity than dealing in and with the landed property being its sole asset does not ipso facto justify the court to depart from the general principles enunciated in *Salomon v Salomon & Co Ltd* …'

[102]
The court reached a similar result in *Re Lewis's Will Trusts* [1985] 1 WLR 102 where the gift under a settlement in a will of certain property bequeathed to a beneficiary was invalid when the settlor at the time of his death only owned the shares of the company holding the property.

Equating company's and members' rights

Civil rights and remedies

[103]
The fruits of any litigation brought on behalf of the company by the minority shareholders against the controller of the company or any parties related thereto in respect of any wrong done to the company only go to the company and not the shareholders who initiated the legal action. Similarly, even if a company has a right of action against any person for any loss and damage that it has suffered, this does not mean that the members of the company have a right of action to sue the person for the loss in the value of their shares resulting from the damage so caused to the company: *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204; *Stein v Blake* [1998] 1 All ER 724; cf *Johnson v Gore Wood & Co* [2001] 2 WLR 72.

[104]
A right of action accruing to a company cannot be enforced by its director, shareholder or employee despite the fact that they or each of them may

have suffered a loss by an act of a wrongdoer. This was made clear in *Burgess v Auger* [1998] 2 BCLC 478 in which the court held that duties owed by a receiver and mortgagee were only enforceable by the mortgagor company which had the equity of redemption and that the mortgagor's director, shareholder or employee cannot as a rule seek to enforce those duties.

[105]–[150]
As the English Court of Appeal emphasised in *Prudential Assurance Co Ltd v Newman Industries (No 2) Ltd* [1982] Ch 204 at 223A–B, shares are merely a right of participation in the company on the terms of the articles of association. The same point was made by Lord Buckmaster in *Macaura v Northern Assurance Co Ltd* [1925] AC 619 at 626 where his Lordship indicated that the shareholder has no right to any item of the company's property but is entitled to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus assets when the company is wound up.

[151]
In *Diamantides v JP Morgan Chase Bank* [2005] EWHC 263, the claim by the plaintiff against the defendant for negligent advice in relation to investments made by the plaintiff through a company in which he acted as the sole shareholder and controller and was the voice for and assets provider to the company was struck out as the plaintiff chose to invest through a corporate vehicle. In addition, his company had also been the defendant bank's customer all along.

Criminal wrong against company

[152]
Notwithstanding the rule that a company is an entity separate from its controllers, this rule would not be allowed to go to extremes where injustice may be caused to companies for a wrong made by its controllers. No doubt, this should be distinguished with situations where charges were laid against a company and those who are the directing mind of the company would have their guilty mind equated with the company for this purpose. As observed by Lord Reid in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, at 170:

> 'A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these; it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company. There is no question of the company being vicariously liable as...He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the company. If it is a guilty mind then that guilt is the guilt of the company.'

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[153]

In circumstances where companies are defrauded by their controllers, they are entitled to pursue claims against their controllers who are not allowed to raise a defence that they are acting as the companies' agents and on their behalf. This logic not only applies to establishing corporate civil rights[1] but also extends to remedying criminal wrongdoings wherein companies are the sufferers. Whilst the imputation of individuals' personal knowledge to the company they control may sometimes produce an absurd result (eg a company and an individual who is its directing mind and will[2] cannot be charged with an offence of conspiracy which requires the meeting of two or more minds: *R v McDonnell* [1966] 1 QB 233), the court will have no difficulty in convicting the directors for conspiracy to defraud the company they control if it can be proved that they have acted dishonestly and deliberately in dealing with the company's property against the company's interest: *R v Sinclair* [1968] 1 WLR 1246.

1 See *Belmont Finance Corp v Williams Furniture Ltd* [1979] Ch 250.
2 For further discussion of this issue, see **Doctrine of alter ego – directing mind and will, [353]–[403]** below.

[154]

The case of *R v Philippou* (1989) 89 Cr App R 290 illustrates the possibility of a person stealing from his or her own company. The argument that the taking of the company's property by its controlling directors acting as its alter ego can amount to a consent by the company cannot be sustained because the company—as a separate legal entity—owns its property which can be stolen by its directors.[1] Even if the company is treated to have consented to the theft by its directors whose knowledge and state of mind is imputed to the company,[2] the House of Lords in *DPP v Gomez* [1993] AC 442 has made it clear that there can still be an appropriation of an owner's property for the purpose of the Theft Act 1968 despite the owner's consent to the act of appropriation. This issue has raised an interesting argument that owners of a family-owned company may commit an act of theft by taking away its money other than in a way permitted by company law.[3] This was the same finding in *Regina (A) v Snaresbrook Crown Court* (The Times, 12 July 2001) in which the court refused an application by A for judicial review of a decision of the Crown Court judge concerning the dismissal of a charge of theft against him as a director for misappropriating the company's property as appropriation could be made with the owner's consent and the key issue was whether the appropriation was dishonest. In *Arab Bank plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262, the fraudulent valuation made by the director in the name of the company was considered by the court, in the context of construction of certain conditions of the insurance policy, as not attributed to a company so as to disentitle it from making a claim under the policy as the director was not the directing mind of the company in relation to the valuation and it

was impossible and contrary to common sense to infer that the director's knowledge of his dishonesty should be transferred to his company.

1 A person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it: see the Theft Ordinance (Cap 210).
2 This was the argument put forward and accepted by the court in the case of *R v Roffel* [1985] VR 511.
3 See the exceptions to the rules concerning capital maintenance in Chapter VI; for this debating topic, see DW Elliott, 'Directors' Thefts and Dishonesty' (1991) Crim LR 732; G Virgo, 'Stealing from the Small Family Business' (1991) CLJ 464.

Creating dual capacities of controlling shareholders and employees

[155]–[200]
On the other hand, in *AG's Reference (No 2 of 1999)* [2000] 3 WLR 195, it was held that it was not sufficient to impose a criminal liability by establishing what was described as a management failure: a poor, inadequate or absence of any system in the company. Equally, even when those who worked in the company may have been unskilled, incompetent, indifferent, apathetic, complacent and careless, it will not suffice for criminal liability to be established if there was no identification of anyone who was solely or principally responsible.

Controlling shareholder as employee

[201]
In *Lee v Lee's Air Farming Ltd* [1961] AC 12, Mr Lee was employed as a pilot by a company that was owned and controlled by him (who was also its only director). Mr Lee was killed in an accident in the course of his employment. The question before the court was whether the estate of Mr Lee could claim for employee compensation insurance for damage suffered during work. It could if Mr Lee was regarded as an employee at the time of the fatal accident. In response to the insurers' argument that it was impossible for Mr Lee, as owner of the company and acting on its behalf, to make a contract employing himself, it was held that:

> 'it is a logical consequence of the decision in Salomon's case that one person may function in dual capacities. There is no reason, therefore, to deny the possibility of a contractual relationship being created as between the deceased and the company' and that 'there appears to be no greater difficulty in holding that a man acting in one capacity can give orders to himself in another capacity than there is in holding that a man acting in one capacity can make a contract with himself in another capacity'.[1]

1 See *Lee v Lee's Air Farming Ltd* [1961] AC 12 at 26 and 30 per Lord Morris of Borth-y-Gest.

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CHAPTER VIII

ACCOUNTABILITY AND ENFORCEMENT – DIRECTORS, COMPANY SECRETARIES AND SHAREHOLDERS

1. Company Officers – Directors and Company Secretary

OFFICERS OF THE COMPANY

[1]
A company is an artificial legal entity and must act through human agents. 'The company itself cannot act in its own person … it can only act through directors': *Ferguson v Wilson* (1866) LR 2 Ch App 77 per Cairns LJ at 89. Lying at the heart of common law is the concept of agency. Apart from the rules of agency, statutory provisions and the company's articles govern, inter alia, the appointment, qualification, powers and removal of officers.

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Concept of 'officer'

[2]
'Officer' in relation to a body corporate is defined in the Companies Ordinance to include a director, manager or secretary. The term is given an open-ended definition that may encompass those occupying senior managerial positions, whatever his or her title, and those who are actively concerned in the management or direction of the company: *Toppam Printing Co Ltd v Champion Dragon Development Ltd* [1986] HKC 371.[1]

1 Under the Securities and Futures Ordinance, an officer is defined under Schedule 1 as a director, manager or secretary of, or any other person involved in the management of, the corporation or any member of the governing body of the unincorporated body.

[3]
For the purpose of section 276 concerning liability for misfeasance or breach of duty, an auditor may be treated as an officer of the company: *Re Kingston Cotton Mill (No 2)* [1896] 2 Ch 279; *Re London and General Bank (No 2)* [1895] 2 Ch 166; *Re Thomas Gerrard & Son Ltd* [1968] Ch 455; *R v Shacter* [1960] 2 QB 252; *Mutual Reinsurance Co Ltd v Peat*

Marwick Mitchell & Co [1997] 1 BCLC 1 per Hobhouse LJ. A similar concept is applicable to the power of the court to summon officers of the company whom the court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs, or property of the company: *Sasea Finance Ltd v KPMG* [1998] BCC 216 per Robert Walker J (at the first instance hearing); *Re The New China Hong Kong Group Ltd* [2003] 3 HKLRD 799, [2003] 3 HKC 252 per Hon Kwan J (as she then was). Solicitors of a company are not officers: *Re Great Wheal Polgooth Co* (1883) 53 LJ Ch 42.[1] For the purpose of the directors' disqualification regime, an officer shall include a shadow director: section 168G(3).

1 Section 2(2) (as amended by the Companies (Amendment) Ordinance 2003) provides a limited exception for professional advisers from falling within the concept of a shadow director by providing that a person shall not be considered to be a shadow director of a company by reason only that the directors or a majority of the directors of the company act on advice given by him in a professional capacity.

Identifying 'officer' for certain purpose

[4]

In many instances, liability is imposed on officers in default under the Companies Ordinance. In respect of offences antecedent to or in the course of winding up of companies under section 271, the term 'officer' shall include any person in accordance with whose directions or instructions the directors of company have been accustomed to act: section 271(3).[1]

1 Apart from the Companies Ordinance, there are other statutes which impose criminal liability on the part of company officers (including directors, secretaries and managers) in respect of any corporate offences committed by the company through the consent or connivance or otherwise attributable to any neglect or omission of the company officers. For a detailed analysis of this topic, see [1904]–[1954] of Chapter III.

[5]–[50]

Concerning the enforcement of duties under the Companies Ordinance by a court order, section 306(1) provides that if a company or its officer, having made default in complying with any statutory requirement, fails to make good the default within 14 days after the service of a notice on the company or its officer requiring the company or its officer to comply with that requirement, the court may, on an application made to it by any member or creditor of the company or by the Registrar, make an order directing the company or its officer (as the case may be) to make good the default within the time specified in the order. Section 306(2) further provides that the costs of such application shall be borne by the company or its officer in default.

[51]

In case of a company winding up, any past or present officer who has misapplied or retained or become liable or accountable for any money or

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