Salomon V Salomon: Have the Liquidator’s Arguments Been Buried with Time?

Daniel Herszberg

Skadden, Arps, Slate, Meagher & Flom, Hong Kong

Follow this and additional works at: http://epublications.bond.edu.au/cgej

Part of the Law Commons

Recommended Citation
Salomon V Salomon: Have the Liquidator’s Arguments Been Buried with Time?

Abstract

Extract:

The decision of the House of Lords in Salomon v Salomon & Co Ltd is considered the ‘classic authority’ for the proposition that a company has a separate legal personality. This principle’s application engenders polarised debate, specifically with regards to corporate groups. Such groups generally operate as a single economic unit, with management of the parent company overseeing each company in the group (including subsidiaries). In Salomon, the liquidator mounted a number of counter-arguments. This critique focuses on the argument that the company was always Salomon's agent in conducting business. In doing so, this critique questions whether the liquidator’s argument has continued significance in light of the agency quasi-exception and the general application of Salomon to corporate groups.

Keywords

shares, debentures, company, creditor

Disciplines

Law

This journal article is available at ePublications@bond: http://epublications.bond.edu.au/cgej/37
I INTRODUCTION

The decision of the House of Lords in Salomon v Salomon & Co Ltd is considered the ‘classic authority’ for the proposition that a company has a separate legal personality.1 This principle’s application engenders polarised debate, specifically with regards to corporate groups. Such groups generally operate as a single economic unit, with management of the parent company overseeing each company in the group (including subsidiaries).2 In Salomon, the liquidator mounted a number of counter-arguments. This critique focuses on the argument that the company was always Salomon’s agent in conducting business.3 In doing so, this critique questions whether the liquidator’s argument has continued significance in light of the agency quasi-exception and the general application of Salomon to corporate groups.

The facts of Salomon are well known and will only be briefly stated.4 Salomon incorporated a boot manufacturing business as a sole trader. This business was transferred to the new company, with Salomon allotting himself secured shares and debentures as consideration. Together with his wife and five children, Salomon subscribed for shares in the new company. Upon the company’s insolvency, the issue arose as to whether Salomon could claim as a secured creditor, ahead of unsecured creditors.5

5 Salomon [1897] AC 22; Phillip Lipton, Abe Herzberg and Michelle Walsh, Understanding Company Law (Lawbook Co, 17th ed, 2014) 34 [2.50].
The House of Lords overruled Vaughan Williams J at first instance, and the Court of Appeal, firmly enjoining the separate legal entity principle into corporate law. Hence, upon satisfying the incorporation formalities, a new distinct entity emerges separate from its directors and shareholders. In Australia, this is recognised under s 124(1) of the Corporations Act 2001 (Cth). This principle operates alongside the notion of limited liability whereby if the company is liable for debts, penalties or damages, its members and directors are not liable.

This paper is divided into three parts. First, the critique analyses the impact of the liquidator’s arguments in shaping the agency quasi-exception. Next, it explores whether a link exists between the liquidator’s argument and the continued debate surrounding the application of Salomon to corporate groups. Finally, this paper considers reform which may address any lingering influence of the liquidator’s argument.

II Agency

By dismissing the liquidator’s argument, Salomon held that a company is not regarded as an agent of its shareholders. Some have gone as far as stating that the essence of Salomon was precisely ‘the rejection of … agency between a corporation and its members in relation to the corporation’s contracts...’ Whilst no explicit principle exists permitting veil piercing in agency relationships, judicial exceptions have emerged whereby legal principles of agency are applied in the circumstances of a particular case to attribute liability to the principal. This section questions whether the emergence of this quasi-exception and the uncertainty surrounding its application highlights the continued significance of the liquidator’s argument.

At the outset, consider the following from Lord Denning MR in Wallersteiner v Moir:

[the subsidiary companies] were just the puppets of Dr Wallersteiner. He controlled their every movement. Each danced to his bidding. He pulled the string...

---

6 Broderip v Salomon [1895] 2 Ch 323.
7 Ibid 336.
8 Salomon [1897] AC 22, 51 (Lord MacNaghten); Lipton, Herzberg and Walsh, above n 5, 34 [2.45].
10 But see Salomon [1897] AC 22, 23, 31 (Lord Halsbury LC), 42-3 (Lord Hershell).
11 JH Rayner (Mincing Lane) Ltd v Department of Trade & Industry [1989] Ch 72, 188 (Kerr LJ) (‘JH Rayner’).
12 In Prest v Petrodel Resources Ltd [2013] 2 AC 415 Lord Walker doubted whether a ‘piercing the corporate veil doctrine’ even existed; See Prest v Petrodel Resources Ltd [2013] 2 AC 415, 488 [35], 503 [82].
13 Jason Harris, Company Law Theories, Principles and Applications (LexisNexis Butterworths, 2nd ed, 2015) 165 [4.18]; Smith, Stone and Knight Ltd v Birmingham Corporation [1939] 4 All ER 116 (‘Smith, Stone and Knight’); Lipton, Herzberg and Walsh, above n 5, 48-9 [2.225]; CASAC, above n 2, 17; For definitions of ‘holding company’ and ‘subsidiary,’ see Corporations Act 2001 (Cth) ss 9, 46.
14 Lipton, Herzberg and Welsh, above n 5, 48 [2.225].
15 Wallersteiner v Moir (No 2) [1974] 3 All ER 217, 238 (emphasis added); Note, this case dealt with piercing the corporate veil due to an agency relationship.
For corporate groups, relationships of agency have been recognised where the parent company exercises such control over the subsidiary that the subsidiary’s acts are deemed as the acts of the parent company.\(^{17}\) In Smith, Stone and Knight, Atkinson J identified six requirements to be established before displacing Salomon.\(^{18}\) These requirements can be summarised as the parent company treating the subsidiary’s profits as its own, appointing the persons conducting the subsidiary’s business, directing everything within the subsidiary and maintaining control over the subsidiary.\(^{19}\) At the outset, the mere fact that a form of agency exception emerged suggests the liquidator’s argument has continued significance.

However, given that Smith, Stone and Knight was delivered in 1939, this does not necessarily support an argument for contemporary significance. Nonetheless, criticisms of this judgment point towards the uncertainty of this exception. In JH Rayner, Kerr LJ stated that it should be confined to its facts and ‘cannot form any basis of principle.’\(^{20}\) Jason Harris has criticised Smith, Stone and Knight as amounting to an attempted restoration of the Court of Appeal’s decision in Salomon, i.e. an endorsement of the liquidator’s arguments, albeit on different grounds.\(^{21}\) Consider the following statement of Toulson J in 1998:

\[
I \text{ do not accept... that as a matter of general approach the court should [use] as guidance the sub-questions posted by Atkinson J... On that approach Salomon’s case would surely have been decided differently...}^{22}
\]

The liquidator’s arguments can be interpreted as contributing to the lack of clear principles in establishing agency relationships. For example, the liquidator’s focus on elements of ‘control’ is effortlessly reconciled with the Smith, Stone and Knight requirements.\(^{23}\) In drawing a connecting line, this aspect of ‘control’ has underscored much criticism of

---

\(^{16}\) Salomon [1897] AC 22, 31 (emphasis added).

\(^{17}\) Lipton, Herzberg and Welsh, above n 5, 48-49 [2.225].

\(^{18}\) For a specific outline, see Smith, Stone and Knight [1939] 4 All ER 116, 121 (Atkinson J); For a summary, see Robert P Austin and Ian M Ramsay, Ford, Austin and Ramsay’s Principles of Corporations Law (LexisNexis Butterworths, 16th ed, 2015) 149 [4.250].


\(^{20}\) JH Rayner [1989] Ch 72, 189.


\(^{22}\) Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia (The Rialto) (No 2) [1998] 4 All ER 82, 92 (emphasis added).

\(^{23}\) Salomon [1897] AC 22, 28; Smith, Stone and Knight [1939] 4 All ER 116.
Smith, Stone and Knight. As recognised in James Hardie, such control is often intrinsic to parent and subsidiary relationships and should not in itself engender the required relationship to pierce the veil. As Ramsay and Noakes note, for corporate groups, ‘control’ has typically been insufficient grounds for piercing the veil. Whilst Smith, Stone and Knight remains good law, such criticisms accentuate the influence of the liquidator’s argument on the uncertain operation of the agency exception.

Thus, we can conclude that the liquidator’s agency argument offers a conceptual footing for going beyond the separate legal personality. Further, the uncertainty and criticism surrounding this exception emphasises the continued significance of the liquidator’s argument. This critique now goes further, questioning whether the liquidator’s agency argument influences the general debate regarding the application of Salomon to corporate groups.

III COMMERCIAL REALITY

The wisdom of stringently applying Salomon to corporate groups has been vigorously debated. The High Court in Industrial Equity Ltd v Blackburn and Walker v Wimborne emphasised that the application of Salomon to corporate groups means that each company in a group is regarded as a separate legal entity distinct from other companies in the group. This section considers the argument that the law essentially ignores commercial

24 Briggs v James Hardie & Co Pty Ltd (1989) 7 ACLC 481, 572, 577 (Rogers AJA) (‘James Hardie’).
28 Harris, Company Law Theories, above n 14, 165 [4.18]; Nyombi, above n 20, 78; Harris, ‘Lifting the Corporate Veil’, above n 22, 8; Boros and Duns, above n 2, 44 [3.2.1], 51 [3.3.1]; For an interesting example of the uncertainty of agency relationships between a company and a natural person, see, eg, Anderson and Commissioner of Taxation [2015] AATA 167, 9-14.
30 (1977) 137 CLR 567 (‘Industrial Equity’); (1976) 137 CLR 1; See also Pioneer Concrete Services Ltd v Yelnah Pty Ltd (1987) 5 ACLC 467 (Young J); Adams v Cape Industries plc [1990] 1 Ch 433; Commissioner of Taxation v BHP Billiton Minerals Pty Ltd [2011] HCA 17 [62] (French CJ, Heydon, Crennan and Bell JJ); Lipton, Herzberg and Walsh, above n 5, 38 [2.80]; For the implications, see Austin and Ramsay, above n 19, 153-54 [4.270]; Cassidy, above n 2, 57 [3.140].
realities regarding the operation of corporate groups.\textsuperscript{31} In doing so, this section explores whether a link exists between this argument and the liquidator’s agency argument.

It would be crass to suggest the liquidator anticipated the emergence of corporate groups and conglomerates. However, by arguing that Aron Salomon be recognised as the true owner of the company due to his degree of control over the company,\textsuperscript{32} the agency argument identifies a key flaw in applying Salomon to corporate groups. The essence of this argument goes beyond recognising that agency relationships exist. Rather, the underpinnings can be identified as the necessity to recognise commercial realities. This notion emerges as a key criticism when applying Salomon to corporate groups.

From a commercial viewpoint, a group is considered a single economic entity, whereby directors of group companies think that ‘what is good for one is good for all.’\textsuperscript{33} This is often reflected by sophisticated information flows between management and shareholders, as well central treasuries.\textsuperscript{34} Accordingly, the present law maintains a different understanding of corporate groups to those in the commercial world.\textsuperscript{35} Rogers AJA in James Hardie encapsulates this point:

\begin{quote}
the law pays scant regard to the commercial reality that every holding company has the potential and, more often than not, in fact, does exercise complete control over a subsidiary…\textsuperscript{36}
\end{quote}

This position has proven increasingly difficult to maintain and implement. Whilst Lord Denning has previously recognised a corporate group as a single economic enterprise in DHN Food Distributors,\textsuperscript{37} this position isn’t supported in Australia.\textsuperscript{38} Nonetheless, judicial developments continue to acknowledge the difficulties of denying commercial realities. In Qintex,\textsuperscript{39} upon the corporate group’s collapse, the court had difficulty in determining the individual company which had undertaken the foreign exchange contracts. Here, given the overall relationship with the group, the brokers considered the particular subsidiary to be of minor significance.\textsuperscript{40} Again, Rogers CJ recognised the inherent tensions of the existing law:

\begin{quote}
\textsuperscript{31} See Berle, above n 30, 344.
\textsuperscript{32} Salomon [1897] AC 22, 31.
\textsuperscript{33} Austin and Ramsay, above n 19, 154 [4.280].
\textsuperscript{34} Philip I Blumberg, The Multinational Challenge to Corporation Law (Oxford University Press, 1993) 138-47; Harris, Company Law Theories, above n 14, 141 [4.11].
\textsuperscript{36} James Hardie (1989) 7 ACLC 481, 577 (Rogers AJA).
\textsuperscript{37} DHN Food Distributors Ltd v London Borough of Tower Hamlets [1976] 3 All ER 462 (‘DHN Food Distributors’).
\textsuperscript{38} James Hardie (1989) 7 ACLC 481, 576-7; Rogers AJA held DHN as inconsistent with Industrial Equity (1977) 137 CLR 567 and Walker v Wimborne (1976) 137 CLR 1.
\textsuperscript{39} Qintex (1990) 3 ACSR 267.
\textsuperscript{40} Ibid.
\end{quote}
... it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become the contracting party...41

Indeed, a departure from commercial practice does not necessarily mean the law is undermined. It could be argued that cases such as DHN Food Distributors and Qintex obsess over the rare cases where the corporate structure inhibits recovery against an individual or company the Court regards as a wrong-doer.42 Companies often organise themselves as corporate groups in order to manage risk, reduce tax liability and provide a focus for management and reporting.43 These legitimate commercial objectives should not be negated. Nonetheless, this analysis demonstrates that the application of Salomon to corporate groups is proving to be so out of touch with commercial realities that it has become increasingly unjustifiable.44 Thus, the law is not simply ‘lagging behind’ the realities of the business world,45 but rather operates in a manner of wilful blindness.

The stringent application of Salomon to corporate groups means the judiciary continues to be enslaved by legal fictions whilst disregarding the realities of such groups. By demanding that commercial realities be recognised, the liquidator’s agency argument can be interpreted as a focal point of contemporary criticism of Salomon. As such, this paper now briefly considers areas for reform.

IV REFORM

The general resistance to an ‘enterprise approach’ renders unlikely comprehensive legislative reform in that direction.46 This section proposes that legislation be enacted which requires the veil to be pierced where the parent company has engaged in an act of wrongdoing through its own actions or the use of the subsidiary.47 Such a reform would provide veil-piercing with a clear principled underpinning of fault without impeding the valid commercial objectives of companies adopting corporate structures. This proposal addresses the spirit of the liquidator’s argument and ensures that the law recognise realities operating behind the legal fiction.

Firstly, such a reform complements existing legislation. Akin to holding directors liable for wrongful conduct,48 this proposal bestows parent companies with equivalent duties, specifically care, diligence and good faith.49 This proposal builds upon the liability of parent companies as shadow directors.50 Whilst this provision’s application will be left to

41  Ibid 268-9.
42  Ibid; DHN Food Distributors [1976] 3 All ER 462;
43  See generally CASAC, above n 2, 20-2.
44  Harris, Company Law Theories, above n 14, 145 [4.11].
45  Hadden, above n 36, 61.
48  Corporations Act ss 180, 181.
49  Anderson, above n 48, 355.
50  Ibid; Corporations Act s 9 (definition of ‘director’ para (b)(ii)).
judicial discretion, it can be presumed to address tangential issues of tortfeasors, undercapitalisation, misuse of phoenix companies, fraud and misrepresentation.51

This reform accords with a gradual move towards recognising the reality of corporate groups operating as a single enterprise. For example, insolvent trading provisions and pooling in external administration.52 This is also evidenced in Australian competition legislation, which combines the group’s market power in appraising its market position.53 Similarly, this reform dovetails with existing taxation and accounting principles, particularly concerning wholly-owned groups.54

Recent English jurisprudence underscores this proposal by providing for an analytical approach when piercing the corporate veil.55 In Prest v Petrodel Resources Ltd,56 Lord Sumption identified the ‘concealment principle’ and the ‘evasion principle’ as providing the analytical basis for piercing the corporate veil.57 Here, the proposal’s provision of a fault requirement effectively synthesises Australia’s existing descriptive categories of veil piercing with Lord Sumption’s more analytical approach.58 Indeed, this may even be said to represent more conventional agency principles.59

Next, by focusing specifically on corporate groups, this proposal enhances clarity in the application of Salomon. Blumberg refers to limited liability within corporate groups as providing parent companies with ‘double limited liability.’60 Legislating entirely in favour of the single enterprise approach would essentially force corporate groups to restrict their investments in order to minimise liability risk.61 In comparison, the current proposal does not impose severe economic changes. By holding parent companies accountable for wrongdoings, this effectively institutes a ‘check and balance’ on the operation of ‘double limited liability.’

---


54 Harris, Company Law Theories, above n 14, 145 [4.12].


56 [2013] 2 AC 415.

57 Ibid; It should be noted that this view was only endorsed by Lord Neuberger and is not the majority view. Further, Prest v Petrodel Resources Ltd was a matrimonial case. Nonetheless, the principles discussed almost certainly have relevance outside of family law.


59 See, eg, Lazarus Estates Ltd v Beasley [1956] 1 QB 702, 712 [Lord Denning].

60 Blumberg, above n 35, ch 1; See also, Harris, Company Law Theories, above n 14, 143 [4.11].

61 Harris, Company Law Theories, above n 14, 173 [4.22].
This reform also provides greater protection to those engaging with group members. Whilst most creditors to corporate groups are large banks who protect themselves through raising interest rates, this does not undermine the fact that creditors are disadvantaged by the denial of commercial realities. Whilst not displacing Salomon, this reform provides a recourse against deliberate manipulation of Salomon. This proposal also addresses the concerns raised in James Hardie, specifically the moral dangers of stringently applying limited liability.

By penalising the wrongful use of a subsidiary company, such reform does not simply recognise commercial realities but ensures that Salomon is not mistreated thereby keeping Australia in general accordance with other common law jurisdictions. This proposal effectively removes an element of uncertainty in the application of Salomon to corporate groups, thus attempting to finally bury the liquidator’s arguments.

V CONCLUSION

In considering the liquidator’s arguments from the perspective of corporate groups, the continued relevance stands out all the more markedly. The liquidator’s agency argument is underpinned by notions of recognising commercial realities. Whilst Salomon is indispensable to any discussion of corporate law, this does not render the liquidator’s arguments immaterial. Rather, their strength lies in the fact that they continue to underpin contemporary uncertainties in the application of Salomon and exceptions to the separate legal entity principle. In doing so, the liquidator’s arguments acknowledge the need for the gradual loosening of Salomon’s ‘iron grip.’

---

63 Anderson, above n 48, 366.
64 James Hardie (1989) 7 ACLC 841; Boros and Duns, above n 2, 52 [3.3.1]; See also CSR Ltd v Wren 1997] 44 NSWLR 463; CSR Ltd v Young [1998] NSWCCR 56.
66 Lipton, ‘The Mythology of Salomon’s Case’, above n 1, 486.
BIBLIOGRAPHY

A Articles/Books/Reports


Austin, Robert P and Ian M Ramsay, Ford, Austin and Ramsay’s Principles of Corporations Law (LexisNexis Butterworths, 16th ed, 2015)


Blumberg, Philip I, The Multinational Challenge to Corporation Law (Oxford University Press, 1993)

Boros, Elizabeth and John Duns, Corporate Law (Oxford University Press, 3rd ed, 2013)

Cassidy, Julie, Corporations Law Text and Essential Cases (Federation Press, 4th ed, 2013)


Companies and Securities Advisory Committee, Corporate Groups: Final Report (CASAC, 2000)


Harris, Jason, Company Law Theories, Principles and Applications (LexisNexis Butterworths, 2nd ed, 2015)


Harris, Jason and Anil Hargovan, ‘Cutting the Gordian Knot of Corporate Law: Revisiting Veil Piercing in Corporate Groups’ (2011) 26 Australian Journal of Corporate Law 39

Huang, Hui, ‘Piercing the Corporate Veil in China: Where it is Now and Where it is Heading’ (2012) 60 American Journal of Comparative Law 743


Lipton, Phillip, Abe Herzberg and Michelle Walsh, Understanding Company Law (Lawbook Co, 17th ed, 2014)

Machen Jr, Arthur W, ‘Corporate Personality (Continued)’ (1911) 24 Harvard Law Review 347

Mann, Trischa (ed), Australian Law Dictionary (Oxford University Press, 2010)

McQueen, Rob, A Social History of Company Law Great Britain and the Australian Colonies 1854-1920 (Ashgate, 2009)


Munday, Roderick, Agency Law and Principles (Oxford University Press, 2010)


Quilter, Michael, Company Law Perspectives (Lawbook Co, 2nd ed, 2014)

Rachagan, Shanthy, Janine Pascoe and Anil Joshi, Concise Principle of Company Law in Malaysia (LexisNexis, 2nd ed, 2010)


Reynolds, Francis M B, Bowstead and Reynolds on Agency (Sweet & Maxwell, 18th ed, 2006)


B Cases

ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron [2005] SASC 204

Adams v Cape Industries Plc [1990] 2 WLR 657

Anderson and Commissioner of Taxation [2015] AATA 167

Briggs v James Hardie & Co Pty Ltd (1989) 7 ACLC 841

Broderip v Salomon [1895] 2 Ch 323

Burswood Catering and Entertainment Pty Ltd v Australian Liquor, Hospitality and Miscellaneous Workers Union, Western Australian Branch [2002] WASCA 354

Commissioner of Taxation v BHP Billiton Minerals Pty Ltd [2011] HCA 17

CSR Ltd v Wren 1997] 44 NSWLR 463

CSR Ltd v Young [1998] NSWCCR 56

DHN Food Distributors Ltd v London Borough of Tower Hamlets [1976] 3 All ER 462

Equiticorp Finance Ltd (in liq) v Bank of New Zealand (1993) 11 ACLC 952

Eurest (Aust) Catering & Services Pty Ltd v Independent Foods Pty Ltd (2000) ACSR 352

Industrial Equity Ltd v Blackburn (1977) 137 CLR 567

JH Rayner (Mincing Lane) Ltd v Department of Trade & Industry [1989] Ch 72

Lazarus Estates Ltd v Beasley [1956] 1 QB 702

Pioneer Concrete Services Ltd v Yelnah Pty Ltd (1987) 5 ACLC 467

Prest v Petrodel Resources Ltd [2013] 2 AC 415

Qintex Australia Finance v Schroders Ltd (1990) 3 ACSR 267

Re FG (Films) Ltd [1953] 1 All ER 615

Re Southard & Co Ltd [1979] 3 All ER 556

Salomon v Salomon & Co Ltd [1897] AC 22

Smith, Stone and Knight Ltd v Birmingham Corporation [1939] 4 All ER 116

Spreag v Paeson Pty Ltd (1990) 94 ALR 679
Walker v Wimborne (1976) 137 CLR 1

Wallersteiner v Moir (No 2) [1974] 3 All ER 217

Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia (The Rialto) (No 2) [1998] 4 All ER 82

C Legislation

Corporations Act 2001 (Cth)