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Abstract
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Keywords
corporate governance, separate legal personality, legal entity, Salomon v Salomon & Co, corporate law

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FRANKENSTEIN INCORPORATED OR FOOLS’ PARLIAMENT?
REVISITING THE CONCEPT OF THE CORPORATION IN CORPORATE GOVERNANCE

By JOHN H FARRAR, Professor of Law, Bond University and Professorial Associate, University of Melbourne.

In this article the concept of the corporation as separate legal person is revisited and the argument is put forward that Salomon v Salomon & Co Ltd was formal reasoning, giving recognition to what the judiciary conceived to be emerging social and economic reality, but was inadequately justified in terms of principle and policy. The concept was also inadequate for doctrinal purposes in corporate decisionmaking; hence the equation of the good of the company with that of its shareholders which is logically inconsistent with the idea of a separate legal person. The Anglo-Australian approach is narrow, ethnocentric and increasingly isolated from German, Japanese and US corporate governance systems. The lack of adequate principle and policy justification accounts for the incoherence of the Anglo-Australian piercing the veil jurisprudence. The answer lies in development of the concept of the corporation as a firm in its social context and consideration is given to the extent to which modern law and economics scholarship and stakeholder theory assist in that development.

A corporation is a legal concept which, through the conferment of separate legal personality, provides legal recognition of bodies of persons as distinctive holders of rights under a collective name, having distinct legal consequences. This is not simply a matter of form and fiction. It is the way in which law defines and regulates economic reality although the relationship between laws and economic reality is not simple. If the corporation is regarded as a separate legal person, questions arise: What is its nature as a legal person? How is this to be ascertained? And what does it entail in terms of institutional framework for decision making? These are troublesome questions of legal and political philosophy and represent a kind of intellectual no man’s land where warring parties venture from time to time to do battle in the night. Some interpret the phenomenon in realist terms, others favour a positivist reduction of the problem.

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2 Freund above n 1, 10 et seq.
to relationships between different sets of rules while others seek a solution in more utopian terms. Lurking in the shadows is anthropomorphism to which the courts resort on occasion.

In 1931 an American law professor, Maurice Wormser of Fordham University who was an able corporate law scholar in his day wrote a polemic work which he entitled ‘Frankenstein, Incorporated’. He wrote at the time of the Depression and echoed the views of the early US judges when he said, ‘Corporations, the creature of the state, owe a deep duty to the state.’ Works like this and Berle and Means, Modern Corporation and Private Property reflected popular wariness of corporations and influenced the development of Administrative Regulation of corporations in the New Deal period. Recently with the election of the New Labour Government in the United Kingdom there has been a renaissance of the stakeholder concept and a stakeholder analysis of society and the place of corporations within it. Although this has been effective election rhetoric and occasioned new literature it is essentially a recycling of old theories left over from the Sixties which has a tendency to reduce the corporation to a Fools’ Parliament. The recycling has been prompted by the wave of so called ‘constituency statutes’ in the USA which have broadened the range of interests which directors can take into account and which have prompted a more principled but as yet inconclusive debate in Canada about amendment of the Business Corporations legislation. Measured against these public and welfarist conceptions of the corporation is the traditional approach of Anglo-Australian Corporate Law of persistent equivocation between treating the corporation as a separate legal person and equation of the corporation with its shareholders. In the middle somewhere lie German Law and German influence on the European Union which have recognised the corporation as a social institution which

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7 Whittlesey House, New York (1931).
8 Ibid Preface viii.
11 Ibid 108, 130 et seq.
13 See the list in ‘Other Constituency Statutes: Potential for Confusion’ American Bar Association Committee (1990) 45 Business Lawyer 2253, 2261.
15 See Rixon F (1986) 49 MLR 446.
accommodates the interest of employees, and the practice of Japanese corporations which sees the corporation in terms of social relations and gives low priority to shareholders but high priority to social, employee and consumer interests.

In this article we will examine the development of the concept of the corporation as a separate legal person, then the legal and economic consequences of the development before considering the heuristic inadequacy of the concept and its ethnocentrism. Then we will briefly review how the courts have attempted to deal with manifest injustices in its application, inevitably resulting from the lack of coherent principle and policy behind its adoption as orthodox legal doctrine. We will then attempt a conclusion in which we point to a need to reformulate the basic doctrine and outline how this can be done. Essentially the argument will be that Salomon v Salomon & Co Ltd was inadequately justified in terms of principle and policy, likewise its extension later to corporate groups. This tipped the balance too much in favour of equity investors at the expense of general and particularly involuntary creditors. It and its aftermath also frustrated the development of a more sophisticated and flexible doctrine of the business corporation as a firm which requires a balancing of competing interests, a position which equates more closely to management’s conception of their role and the mission of many major corporations. Law-and-economics and stakeholder ideas will be reviewed to consider whether and to what extent they can contribute to the development of such doctrine.

The Development of the Concept of the Corporation as a Separate Legal Person

Roman law recognised certain types of body as having corporate status and these ideas influenced Canon Law. Roman and Canon Law ideas influenced the development of the Common Law ideas of corporations. The question of limited liability of members of corporations came later although it was often assumed.

Early forms of corporation were eleemosynary, existing to pursue charitable objects of their founder. Some of these were incorporated by Papal Bull or Royal Charter. In the case of ancient corporations there was a presumption of a lost grant.

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17 Ibid Chapter 3.
18 Digest 3.4.1.
20 In Banco Regis Edmunds against Brown and Tillard (1668) 1 Lev 237; 83ER 385.
The corporations existed for the public benefit.\(^{24}\) There was also a notion of public benefit in the incorporation of early trading corporations such as the Muscovy Company, the East India Company, and the Africa Company. Such bodies existed for mixed public and private purposes.\(^{25}\)

This tendency was followed in the early history of the United States of America.\(^{26}\) Corporations were social organisations 'midway between the state and the individual, owing their existence to the latter’s need of organisation and the former’s inability to supply it.'\(^{27}\)

John P Davis in his massive work, Corporations: A Study of the Origin and Development of Great Business Combinations and of Their Relation to the Authority of the State\(^{28}\) in 1905 wrote that corporations have changed from divisions of society to associations of individuals.

The early theory of incorporation was predicated on the idea of privilege to be granted on certain terms.\(^{29}\) With the modern company registration system from the UK Companies Act 1844 and its Australian counterparts, there is the development of an alternative theory based on the corporation as a contract.\(^{30}\) This was reflected in increasing latitude with regard to corporate constitutions.

**Salomon**

The concept of the corporation as a separate legal person was not clearly recognised until 1897 with the House of Lords decision in *Salomon v Salomon & Co Ltd.*\(^{31}\)

The early companies legislation merely referred to the subscribers forming themselves into an incorporated company and did not spell out the consequences in any detail. As a learned commentator in the Law Quarterly Review of 1897 stated: ‘Our Legislature … delivered itself on the Companies Acts in its usual oracular style, leaving to the Courts the interpretation of its mystical utterances.’\(^{32}\)

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\(^{25}\) Gower op cit.

\(^{26}\) Hurst above n 24.

\(^{27}\) Davis JP, Corporations: A Study of the Origin and Developments of Great Business Combinations and of Their Relation to the Authority of the State, B Franklin, New York (1909) 264. See too Dodd above n 9 especially (1932) 45 Harv L Rev at 1148-1149.


\(^{30}\) Ibid 19, 93 et seq.

\(^{31}\) [1897] AC 22 (HL).

The facts of *Salomon v Salomon & Co Ltd* were as follows: Aron Salomon was a boot and shoe manufacturer trading as a successful sole trader in the East End of London for over 30 years. There was pressure by members of the family to give them a share in the business and he wished to extend the business. He therefore formed a company and sold his business to the company. At the time the legislation required a company to have a minimum of seven members. A Salomon and Co Ltd had Salomon himself and six members of his family who held one share each as nominees. Thus the company was in reality a ‘one-man company’.

The price paid by the company for the transfer of the business was on paper over £39,000, ‘which’, 33 Lord Macnaghten said, ‘represented the sanguine expectations of a fond owner rather than anything that can be called a businesslike or reasonable estimate of value’. Although worthy of comment, this fact ultimately had no bearing on the case in the House of Lords. The purchase price was to be paid as to £30,000 out of money as it came in, which Salomon immediately returned to the company in exchange for fully paid shares, £10,000 in debentures and the balance (except for £1,000) to be used to pay the debts. The debentures were an acknowledgment of indebtedness by the company secured on its property and effects. At the end of the day Salomon received about £1,000 in cash, £10,000 in debentures and half the nominal capital of the company in issued shares. The company fell upon hard times. There was a great depression in the trade and strikes of workmen. In view of the latter, contracts with public bodies on which the company relied were farmed out amongst a number of different firms. Salomon attempted various strategies to get the company back on its feet. He and his wife lent it money. He mortgaged his debentures to obtain the necessary funds which he loaned to the company. The mortgagee was registered as the holder of the debentures. Still the company did not prosper and it went into receivership and then liquidation. There was a forced sale of its assets. There was enough to enable the liquidator, if he wished, to pay the mortgagee but not enough to repay the debentures in full or the unsecured creditors. In the course of the liquidation the mortgagee of the debentures brought a claim under the debentures against the company. The liquidator attempted to resist the claim by arguing that the debentures were invalid on the ground of fraud.

At first instance Vaughan Williams J, a bankruptcy expert, looked upon the case with a jaundiced eye. He disapproved of the one-man company which was then a new practice and thought he detected fraud. He held that the company was merely acting as Salomon’s nominee and agent and therefore Salomon as principal had to indemnify the company’s creditors himself.

Salomon appealed to the Court of Appeal which turned down his appeal, but largely on the different ground that Salomon was a trustee for the company which was his mere shadow. 34 Both the first instance judge and the Court of Appeal thought that a one-man company was an abuse of the Companies Act.

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33 [1897] AC at 49.
34 See Lindley LJ at [1895] 2 Ch 323 at 336. Lindley LJ was an expert on partnership and company law and learned in Jurisprudence. He translated a work on German legal theory.
Salomon appealed to the House of Lords which totally rejected the rulings below. A one-man company was not an abuse of the Companies Act, all the relevant formalities had been complied with and the Act was silent on the question of beneficial interests and control. A Salomon and Co Ltd was different from Salomon as an individual. In deciding this the clarity of its decision was not matched by the articulation of a coherent basis in either principle or policy. Indeed the speeches of the law lords give different bases for the decision. Lord Halsbury LC saw the view of the Court of Appeal as involving a logical contradiction. Sometimes it regarded A Salomon and Co Ltd as a company and sometimes it did not. Lord Watson mentioned a new point, namely that the creditors of the company could have searched the Companies Register to find out the name of the shareholders and their failure to do so should not impute a charge of fraud against Salomon. Lord Herschell largely based his speech on the intention of the statute to protect shareholders by limiting their liability. The speech of Lord Macnaghten, which is more comprehensive, is regarded as a legal classic. He states quite firmly 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.

Although regarded as a legal classic by undiscriminating lawyers it is largely tautologous reasoning. Lord Davey was more pragmatic. He considered that it was possible that the result would not have been contemplated by the legislature and might have been due to a defect in the legislation. He also mentioned that it was not argued that there was no association. He was impressed with the absence of a trust and rejected the arguments based on fraud. Lord Morris simply agreed with the others.

**Critique of Salomon**

The stark recognition of separate legal personality of what was in effect a one man firm to the prejudice of creditors startled contemporary commentators who found inadequate justification in terms of principle and policy. Thus both Sir...
Fredrick Pollock in a note in the Law Quarterly Review\textsuperscript{43} and the Hon. Walter Lindley editing the Sixth Edition of his father’s 
*Treatise on the Law of Companies*,\textsuperscript{44} wrote that such actions were never contemplated by the legislature. Nevertheless the concept became firmly established and was extended to corporate groups in due course, again without any adequate reasoning in terms of principle and policy other than a dogmatic application of *Salomon* itself.

The House of Lords’ decision in *Salomon* has been criticised as going too far. The contemporary comment of Pollock in the Law Quarterly Review\textsuperscript{45} was that the House of Lords had recognised that one trader and six dummies would suffice and that the statutory conditions were mere machinery. ‘You touch the requisite button and the company starts into existence, a legal entity, an independent *persona*.’ There was nothing startling in that. Once limited liability was recognised the creditors must look at the capital - the limited fund - and that only. Nevertheless, from the point of view of statutory construction it was thought that such a decision would have been impossible twenty or thirty years earlier. The reference in the Act to the persons being ‘associated’ would then have predicated a partnership.

A more drastic criticism was that of the late Professor Sir Otto Kahn-Freund\textsuperscript{46} who thought that the decision was ‘calamitous’. The courts, while developing fiduciary principles to protect shareholders, had failed to mitigate ‘the rigidities of the ‘folklore’ of corporate entity in favour of the legitimate interests of the company’s creditors’. Not only this but the incongruity permeated the whole of legal business life. He thought that the answer lay in:

(a) raising the cost of incorporation;
(b) the introduction of minimum capital for all companies not exempted by the Department of Trade and a minimum subscription on incorporation;
(c) the abolition of private companies;
(d) a general clause deeming those companies under the control of ten persons to be the agents of those persons.

A minimum capital has now been introduced for public companies in the United Kingdom as a result of the Second European Union Directive\textsuperscript{47} but under-capitalisation does not feature in the piercing the veil cases.\textsuperscript{48}

A more general criticism of the decision rests on fundamental principle and policy. If we adopt Justinian\textsuperscript{49} as a convenient starting place on principle - that the purposes of the law are to cause a person to live honestly, not to harm

\textsuperscript{43} [1897] 13LQR6. Pollock was editor and is assumed to have been the author of the case note.
\textsuperscript{44} *A Treatise on the Law of Companies Considered as a Branch of the Law of Partnership*, (6th ed) Sweet & Maxwell, London (1902) Vol 1, 160
\textsuperscript{45} [1897] 13 LQR6.
\textsuperscript{46} (1944) 7 MLR 54.
\textsuperscript{47} 77/91/EEC ; 20 OJL 26 31 January 1977.
\textsuperscript{48} See eg Farrar above n 29, Chapter 7.
\textsuperscript{49} Institutes Book I-1-3
another and give to each his or her due - then *Salomon* is potentially deficient on each count. It - and its extension to corporate groups - facilitate fraud or at least dishonest conduct. Tort claimants can be left without effective redress and it facilitates undercapitalised businesses. In terms of policy it fails to identify the legitimate ends of incorporation and provides the basis of a massive shift of risk to creditors including involuntary creditors who have no choice in the matter.

The legal and economic justifications put forward by the law lords in *Salomon* were formalistic and simplistic. The practical effects of their decision were:

1. to legitimate the one person company;
2. to allow a corporate controller to escape personal liability and to succeed as a secured creditor where he held security even though this was validated substantially by himself.

The results were to encourage the incorporation of small business which effectively transfers some of the risk to general and involuntary creditors since finance creditors insist on personal collateral. Also it eliminated the potentially complex questions of liability to creditors for corporate debts which had bedevilled the earlier law. These aspects were simply not discussed in *Salomon*.

Since *Salomon* the concept has been extended to corporate groups and linked with another legal and economic doctrine namely the end or purpose of the corporation. This teleological aspect was written into the early constitutions of corporations by the objects clause but easily bypassed by appropriate draftsmanship. It survived in another form in the concept of the good of the company and proper purpose in directors’ duties and was linked by the economists with long term shareholder gain. We shall see how this arose, at least as a matter of law, due to the heuristic inadequacy of the concept of the corporation. The idea that the corporation as the aggregate of shareholders was contradictory of *Salomon* never seems to have been raised. The alternative idea of the corporation as a separate legal person representing a firm rather than a conveniently bracketed group of shareholders which would have taken *Salomon* to its logical conclusion never seems to have taken off. Nevertheless the idea of a corporation as an incorporated firm has more connection with reality and more connection with the complexity of modern management.

**The Heuristic Inadequacy of the Concept as Legal Doctrine**

In spite of the dogmatic clarity of *Salomon* the courts have found that the separate legal personality of the corporation was inadequate on crucial occasions to perform the tasks set for it. Agency and organic approaches have been used to fill the gap and more recently there has been a frank statement that a corporation is only a legal fiction and represents nothing as such but only the
relevant legal rules. To accommodate a corporation into the rest of the law is simply an elaborate exercise in rule interpretation and application. This approach, although elegant, is reductionist. While there is some justification for it as a legal proposition it scarcely stands as a proposition of social or political philosophy or social fact. Even the justification as a legal proposition rests on tautology, and the courts have found it necessary to supplement with other doctrine on occasion. Thus the axiomatic duty of directors and of shareholders in general meeting is to act for the good of the company; but what is the company for this purpose? The abstraction and fiction do not help. They seem to beg the question in the absence of a conception of the corporation as a firm.

As a result in three key areas namely directors’ duties, constitutional change and takeover defences, the courts have found the necessity to go beyond the fiction. In the first and second cases this has led them to consider the interests of the shareholders as a general body. Recently it has been recognised that in the case of insolvency or near insolvency this gives way to the creditor interest. In the case of takeovers there has generally been an equation of the corporation with its shareholders but on rare occasions the recognition of the corporation as a firm which potentially takes in a broader range of stakeholders. The main problem has been to identify the basis on which the term ‘stakeholder’ is being used. Is it a legal concept, a moral concept or simply a loose term of managerial theory?

In the USA the junk bond financed asset stripping tender offers of the 1980’s led to a number of state constituency statutes which have authorised the directors to consider as a matter of law a broad range of specified corporate stakeholders.

As the ABA Committee on Corporate Laws stated in its Report ‘Other Constituencies Statutes: Potential for Confusion’ in 1990:

All the statutes incorporate one or more of the following provisions:

51 Meridian ibid.
52 See Rixon F, ‘Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association’ (1986) 49 MLR 446.
54 Ibid Chapter 11.
56 Ibid.
57 Ibid para [8.100].
1. The directors may consider the interest of, or the effects of their action on, various non-stockholder constituencies.

2. These constituencies may include employees, customers, creditors, suppliers, and communities in which the corporation has facilities.

2. The directors may consider the national and state economies and other community and societal considerations.

4. The directors may consider the long-term as well as the short-term interests of the corporation and its shareholders.

5. The directors may consider the possibility that the best interests of the corporation and its stockholders may best be served by remaining independent.

6. The directors may consider any other pertinent factor.

7. Officers may also be covered.

In most of the state statutes, the relevant wording is qualified by words such as ‘in considering the best interests of the corporation’. 61

In the case of the Connecticut statute the act mandates directors to take the specified interests into account but this is unusual. Other states tend to simply allow directors to do so. 62

In the United Kingdom the Companies Act 1980 introduced a more limited provision which is now section 309 of the Companies Act 1985. This provides:

309 - (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

The ABA Committee states:

Several aspects of this (UK) formulation are noteworthy. First, it makes it mandatory for directors to take into account the interests of employees.

61 Ibid 2265.
62 Conn Gen Stat Ann SS 33-313(c).
However, by providing that the duty is ‘owed by (the directors) to the company (and the company alone)….’ it was apparently intended that the duty could be enforced only by the company or in the limited circumstances permitted in England in a derivative suit brought by a shareholder; there is no right on the part of any employee, as an employee, to enforce the duty put upon directors to consider the interests of employees.63

In spite of the wording of section 309 the assumption in the United Kingdom is that this merely legitimates consideration of the interests of employees. They can be considered along with the interests of members. Directors are in effect mandated to perform a balancing act. It is to be noted also that there is no reference to creditors in the section.64

The Law and Economics Literature

In the last 30 years there has been a growth of the law and economics literature on companies which provides a sharp contrast to legal reasoning about corporations and provides some useful insights into policy debates. The origins of this approach lie in Ronald Coase’s paper on the ‘Nature of the Firm’ in *Economica*65 in 1937. Henry Manne developed some ideas about management66 and the different corporate systems67 and invented the idea of the market for corporate control.68 Today it is perhaps true to say that there is a reasonably consistent school of thought which is built upon Coase’s idea of the firm as a team method of production; Alchian and Demsetz’s explanation of the separation of ownership and control in terms of specialisation;69 Fama and Jensen’s explanations of control systems in different types of organisation;70 economic theories of voting;71 economic theories of the monitoring role of markets;72 and theories of the efficiency of markets as elaborate information systems.73 Let us consider the main ideas of this school.74

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63 Op cit 2263.
65 (1937) 4 *Economica* (NS) 386.
68 ‘Mergers and the Market for Corporate Control’ (1965) 73 *J Pol Econ* 100.
The corporation is a species of firm.\textsuperscript{75} It is a characteristic of modern western economies that production is typically carried out by firms, not by individuals although logically this is not a necessary consequence of the price system. It is theoretically possible for all production to be carried out by individuals but as society and technology become more complex this becomes difficult and costly. The firm then represents to some extent an alternative to the price system and instead of a host of market transactions the defining characteristic of a firm is in a \textquote{team use of inputs and a centralised position of some party in the contractual arrangements of other inputs.}\textsuperscript{76} The firm produces economies in transaction costs.\textsuperscript{77}

The corporation evolved as a distinct species of firm primarily as a method of solving problems encountered in raising substantial amounts of capital.\textsuperscript{78} As such it is a kind of standard form contract.\textsuperscript{79} The capital raised enables an elaborate organisation to be set up with professional management. Instead of a series of separate investment contracts and contracts with the various factors in production there is substituted the nexus of contracts constituted by the company.\textsuperscript{80} This and the existence of limited liability facilitates the growth of corporate firms.

The corporate constitution cannot and does not attempt to cover everything. Some things are left to a vote of the shareholders in general meetings. Voting can thus be seen as an aspect of contracting and the right to vote is vested in those with the residual claim to the firm’s income.\textsuperscript{81}

The separation of shareholding and management is due to specialisation.\textsuperscript{82} Decision management is separate from risk bearing and, with limited liability and the possibility of diversified investment, risk bearing itself is reduced.\textsuperscript{83} The diversified shareholder is not usually skilled in management nor even necessarily interested in the detailed operations of the companies in which he or she invests. The growth of institutional investment is a further step on the road of diversification.\textsuperscript{84}

\textsuperscript{75} Coase, op cit; Buchanan NS, \textit{The Economics of Corporate Enterprise}, H Holt, New York (1940) 15.
\textsuperscript{76} Alchian and Demsetz, op cit 777.
\textsuperscript{77} Coase, op cit.
\textsuperscript{79} Posner, op cit 369.
\textsuperscript{80} Fama and Jensen, above n 70, 302
\textsuperscript{82} Fama and Jensen, above n 70, 327 et seq.
\textsuperscript{83} Ibid 332.
\textsuperscript{84} Ibid pp 337 et seq.
The separation of ownership and control gives rise to agency costs because of the opportunities for conflict of interest. Agency costs are, however, limited by the separation of decision management (the initiation and implementation of decisions) from decision control (the ratification and monitoring of decisions). The board of directors of a listed company in this scheme of things controls top level managers. This is a system of internal control. To some considerable extent this is policed externally by the markets in which the company operates. First, there is the product market. Management inefficiencies will affect the survival or competitiveness of the company. Secondly, the public listed company competes in the market for investment capital. A well run company will be more likely to obtain investment funds on better terms than one that is less well run. The share prices reflect all knowledge available to the market. Thirdly, the company and its management participate in the market for management itself. Management is a specialised form of labour and is a marketable commodity. The fourth market in which the company operates is the market for corporate control. Larger and more efficient companies will be constantly on the lookout for companies to take over where the existing management is making inefficient use of the corporate assets.

Management shirking is also policed by the system of auditors and by the case law fiduciary duties which have been augmented by statute. These duties are regarded by writers of this school as an elaborate standard form contract which avoids the need for a host of individual management bonding contracts. The generality of the case law principles is seen as an advantage.

Some law and economics scholars criticize the US constituency statutes on the grounds, first that they conflict with the underlying premise of corporate laws that fiduciary duties should only be owed to the firm’s residual claimants, secondly that they require directors to serve too many masters and thirdly that they fail to recognise the need to protect the residual claimants as the group which faces the most difficult contracting problems with respect to defining the duties owed to them by the directors.

On the other hand an experienced US corporate counsel, Morey McDaniel, has argued:

> With Pareto efficiency as the economic goal, it is possible to derive objective standards for interpreting constituency statutes. The most important standard is a dual goal:

86 Manne (1965) 73 *J Pol Econ* 110; Fama and Jensen, above n 70, 312 et seq; Fama above n 85, 292 et seq.
88 Fischel, above n 87.
90 Ibid 36.
Maximize stockholder gain.
Minimize stakeholder loss.

Statutes that enable directors to eliminate or mitigate losses to other constituencies help assure that a transaction in fact produces net gains in social wealth.

**Separate Legal Personality - Anthropomorphism as Ethnocentrism**

The rigour of the Anglo-Australian concept of the corporation as a separate legal person and its traditional equation since the mid-nineteenth century with its shareholders have been distinctly ethnocentric phenomena.

Civil Law based jurisdictions including Japan have never recognised fully the two aspects of the doctrine. German Company Law from the Weimar period recognised a broader range of stakeholders in the corporation and Japanese corporate governance emphasises the corporation as a social institution with shareholders ranking lowest in the scheme of things.\(^92\)

If we take Germany, article 14(2) of the Federal constitution states ‘Property imposes duties. Its uses should also serve the public good.’\(^93\)

The objectives of German companies do not stop at profit maximisation but recognise a broader concept of the interest of the company as a whole.\(^94\) Institutionally this broader conception of the company is reflected in works councils and worker directors on the supervisory boards in the two tier board system.\(^95\)

The two tier board system dates back to the beginning of modern German corporations law. It was intended as a substitute for a state charter and continuous state control. It linked persons other than the owners with the enterprise.\(^96\)

It is obligatory for all Aktiengesellschaften (public companies) but not for Gmbhs which are the equivalent of proprietary companies. Nevertheless a number of Gmbh have informal advisory boards. Even a Gmbh which normally employs at least 500 employees must have a supervisory board under the co-determination provisions of the Works Constitution Act 1952.\(^97\)

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92 See generally Charkham J above n 16.
93 Charkham above n 16, 10.
94 Ibid 10-11.
95 Ibid 12 et seq.
97 Op cit 7.
The Japanese system although influenced by German and US laws, is marked by underlying social concepts of obligation, family and consensus. In this system shareholders tend to rank lowest in the list of stakeholders and a corporation is seen as a complex form of relational contract in which the primary enforcement system is social rather than legal. This has been described in the following way by a leading Japanese commentator:

The Japanese concept of a corporation, based on this commune or village concept, is fundamentally different from the Western model, which sees the stockholders as the owners of the corporation and the work force as employed labor.

Many Japanese chief executives, when asked what they consider their main responsibility, will say that they work for the well-being of their people. Stockholders do not rank much higher than bankers in their list of concerns.

In an interesting recent study by Dr Ivor Francis entitled *Future Direction - The Power of the Competitive Board* Australian directors were asked to rank in priority, the following:

- Shareholders
- Employees
- The Community
- Customers
- The Future
- The Company
- Suppliers
- Lenders
- The Nation
- Other

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98 Charkham op cit 70.
The results are shown in percentage terms in the Diagram along with the corresponding results for Japanese and US directors. These show that Australian directors, like their US counterparts, overwhelmingly (74%) give first priority to shareholders, notwithstanding the fact, that the law states unequivocally that a director’s first duty is to the company. This contrasts strongly with the results for Japanese directors where the company and customers ranked highest, followed closely by employees.

101 Ibid 354.
102 Ibid 353-4.
The Courts’ Unprincipled Approaches to the Injustice of the Concept

Given the lack of a coherent basis for *Salomon* in principle and policy it is perhaps inevitable first that injustice can arise in its application and secondly that the courts’ departures from it have not been easy to explain and justify in terms of principle and policy. We lack a clear idea of the legitimate ends of corporation.

The orthodox approach to the application of *Salomon* is that the company is a separate legal person and, in the case of a group of companies, the parent company and each subsidiary are separate legal persons. Each as a necessary consequence is solely responsible for its own debts.

There are some exceptional cases where the courts have pierced the veil. In a number of these this has been on the basis of the corporations as a facade or on the basis of what they conceive to be the reality of a group enterprise as a single economic entity. The facade cases have usually been at one end of the spectrum and the enterprise cases at the other. Facade is used as a category of illusory reference to express the court’s disapproval of the use of the corporate form to evade obligations, although the courts have failed to identify a clear test based on pragmatic considerations such as undercapitalisation or domination. The main group enterprise cases have been compulsory acquisition cases where the court sees no harm in the arrangements and it would be unjust for the court to rely too heavily on technicalities. Whereas the facade cases, which represent no clear principle, have generally won approval, the group enterprise cases, which are clearer, although unorthodox, now represent a backwater.

The orthodox modern approach is reflected in the English Court of Appeal decision in *Adams v Cape Industries Plc* in 1990, where the piercing of the veil argument was used to attempt to bring an English public company, which was the parent company of a group which included subsidiaries in the United States, within the jurisdiction of the courts of the United States. The Court of Appeal rejected the single group entity argument, and held that it was a legitimate use of the corporate form to use a subsidiary to insulate the remainder of the group from tort liability. There was no evidence to justify a finding of agency or facade.

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103 See Farrar above n 29, Chapter 7 and Farrar JH, ‘Legal Issues Involving Corporate Groups’ (1998) 16 C & SLJ 184 on which this is based.
104 *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL).
105 Farrar JH, above n 103, 185.
107 See eg *Adams v Cape Industries* [1990] Ch 433.
109 Farrar above n 103, 185.
110 See *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116; *DHN Food Distributors Ltd v Tower Hamlets LBC* [1976] 1 WLR 852.
111 Farrar above 103, 185.
The Court of Appeal followed the House of Lords in the Scottish appeal in Woolfson v Strathclyde Regional Council, which had rejected the earlier reasoning in the English Court of Appeal in DHN Food Distributors Ltd v Tower Hamlets LBC. However, the court felt that earlier authorities provided sparse guidance as to the principles which should guide the court in determining whether or not the arrangements of a corporate groups involved a facade.

Counsel had argued that the court should lift the veil where the corporate structure attempts to evade: (i) limitations imposed on conduct by the law; (ii) such rights of relief as third parties already possess; and (iii) such rights of relief as third parties might in the future require. On the basis of the authorities, it would be safe only to accept (i) and (ii); (iii) seems to go beyond the present law.

On the other hand, in two cases involving the granting of injunctions the courts have been inclined to take a more flexible approach. Thus in Aiglon Ltd and L’Aiglon SA v Gau Shan Co Ltd the court granted an injunction against a company in connection with a liability owed by its affiliate where there was evidence of transactions at undervalue. Also, in TSB Private Bank International SA v Chabra, Mummery J was prepared to countenance that a company was the alter ego of its controlling shareholder and granted an injunction against it in respect of a claim by the shareholder.

Australian authority has generally followed the mainstream UK authorities in spite of the increasing awareness of judges, such as Andrew Rogers, of the need for reform to bring the law into contact with commercial reality. Thus in Pioneer Concrete Services Ltd v Yelnah Pty Ltd we have a useful review by Young J of the English, New Zealand and Australian authorities in the context of construction of a complex commercial agreement.

In Briggs v James Hardie & Co Pty Ltd Rogers AJA referred to the unity of enterprise theory in cases such as DHN, and thought that its adoption may have been foreclosed to Australian courts below the High Court as a result of the decision in Industrial Equity Ltd v Blackburn. In that case the High Court held that, where a parent company had full and effective control over the funds of a subsidiary and the way they dealt with them, the profits to which it could look for the purposes of the declaration of dividends were confined to those already within the parent company. Similarly, in Walker v Wimborne Mason J emphasised the principle of separate legal personality of members of a group and the need of directors of each company to consult its interests and its interests alone in deciding whether to make payments to other companies.

117  (1986) 5 NSWLR 254.
118  (1989) 16 NSWLR 549.
119  (1977) 137 CLR 567.
120  (1976) 137 CLR 1 at 6-7.
There have been similar conservative trends in New Zealand\textsuperscript{121} and Canadian\textsuperscript{122} case law which stand in stark contrast to the greater willingness of US courts to pierce the veil on a number of different policy bases, including domination, unity of enterprise and undercapitalisation.\textsuperscript{123}

In US corporations law, according to Professor Phillip Blumberg,\textsuperscript{124} a leading US scholar, traditional piercing the veil jurisprudence has been on the \textit{doctrinal} bases of instrumentality, alter ego and identity. The instrumentality doctrine is based on:

- control by a shareholders to such an extent that the corporation has no separate existence of its own;
- use of a corporation to perpetrate some fraudulent or wrongful act; and
- conduct resulting in loss to creditors.

The alter ego doctrine is similar, but is used in the case of affiliated corporations when:

- there is such unity of ownership and control that the corporations have ceased to be separate, so that one is the alter ego of the other; and
- application of separate legal personality would sanction fraud or otherwise produce an inequitable result.

The identity doctrine is basically the same. Professor Blumberg has argued strongly\textsuperscript{125} for the development of an enterprise doctrine in respect of corporate groups but, as in the British Commonwealth, this is not yet established.

**Conclusion**

We have seen above that \textit{Salomon} represented a development which was inadequately justified in terms of principle and policy and shocked contemporaries and that this trend was continued in its extension to corporate groups. The policy behind the shift of the law from a privilege approach to incorporation to a freedom of contract approach was never adequately

\textsuperscript{121} \textit{Re Securitibank Ltd (No 2)} [1978] 2 NZLR 136.
\textsuperscript{124} See Blumberg PI, \textit{The Multinational Challenge to Corporation Law - The Search for a New Corporate Personality} OUP, New York (1993) 84-88.
\textsuperscript{125} Ibid Ch. 5.
addressed. The public benefit or prejudice in this transition was never considered by the House of Lords, to the detriment of ordinary and involuntary creditors. At the same time the concept has proved at key times to be heuristically inadequate as a matter of fundamental legal doctrine. Resort has been had to an association concept in the absence of a more sophisticated concept of the corporation as a firm. Comparative corporate governance also shows the ethnocentrism of the Anglo-Australian concept. By contrast a number of states in the USA legitimate consideration by management of a broader range of stakeholders. German and Japanese corporate governance systems embrace a broader more flexible concept of the corporation. Added to all this is the lack of a coherent approach in principle or policy by the British Commonwealth Courts in departing from *Salomon* where there is manifest injustice. Any advance from this unsatisfactory state of affairs must return to basics and take into account the fact that the corporation is in no real sense a person but simply and more abstractly a human agency operating a pool of capital devoted to distinct purposes pursued under certain definite conditions - a holder of rights yes but not a person in the sense of distinctive individuality.\(^{126}\) On the other hand a corporation is more than a fictional bracket round its shareholders and represents some sense of a firm which is a social institution characterised by unity, distinctiveness and continuity.\(^{127}\) Given that the latter characteristics are more typically present in a listed public corporation than in a small incorporated firm this may entail some separate legislative treatment of the latter\(^{128}\) or indeed some fundamental legislative reappraisal of the facts and actual decision in *Salomon v Salomon & Co Ltd*\(^{129}\) in the light of modern insolvency law.\(^{130}\) These are serious questions to be addressed and cannot be answered by mindless repetition of *Salomon*’s so called principle as some kind of mantra or in equally mindless denigration of the corporation as a form of Frankenstein Incorporated. Nor does the answer simply lie in a glib resort to the stakeholder concept which is merely a fashionable doctrine which begs this and many other questions which go beyond the focus of this article.

The law and economics depiction of the corporation as a nexus of contracts provides some useful insights once it is recognized that contract does not mean contract in the legal sense but an individual exchange relationship.\(^{131}\) This helps to explain the basis of the various ‘stakes’ in a way which escapes the uncertainties of an ethical basis. It is suggestive of possible solutions in terms of institutional framework but perhaps needs to be supplemented by broader policy

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127 Ibid.
129 [1897] AC 22 (HL).
objectives. In particular the arguments against the constituency statutes seem overstated and it seems possible to accommodate them within Pareto optimality. As we have seen constituency statutes which enable directors to minimize losses to other constituencies help to achieve an overall net gain in social wealth. The agency theory of the firm is less helpful for our purpose and suffers from an innate reductionism. A corporation is a more complex social institution than a principal and agent relationship although there are similarities and historical connections.

Doctrine and reform based on the idea of the corporation as a firm would involve:

1. a reconsideration of the scope of directors’ authority and shareholder power in general meetings;
2. some institutional recognition of employees in the structure of the corporation;
3. some sense of basic capitalisation and legislative recognition of the legitimacy of consideration of the creditor interest by directors even before insolvency;
4. and as a result of (1)-(3) the articulation of some sense of the legitimate ends of incorporation.

Above and beyond that lies the need to re-educate a whole generation to the fact that corporations exist in society as an important source of rights but also with some concomitant social obligations as the price to be paid for recognition of those rights. This is a projection into the corporate universe of an approach to the rights and duties of individuals in society which is predicated by a basic principle of reciprocity.

As Adam Smith wrote in The Theory of Moral Sentiments ‘All the members of the human society stand in need of each other’s assistance ... where the necessary assistance is reciprocally afforded ... the society flourishes and is happy.’ This was the moral background to his concept of the Invisible Hand of the Market which needs to be emphasized for the sake of balance and accurate

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133 See eg. Macey above n 89 and compare McDaniel above n 91, 161-2
134 See McDaniel above n 91, 162.
135 See Eisenberg above n 131 and Clark above n 133, 196 et seq.
136 See McDaniel above n 133, 152-3
138 See Ford’s Principles of Corporations Law (9th ed) [para 8-100].
139 See Farrar’s Company Law (4th ed) 78.
142 Pt 3, Sec 3, Para 7 and Pt 2, Sec 2, Ch 3, Para 1.
depiction of his views in view of his classical status. Without the underlying social order resulting from reciprocity markets cannot function effectively. The relationship of law to social order and economic systems is complex.

Professor Warren Samuels, a US Economist, wrote in 1987: ‘The doctrine of the affirmation of the corporation as a person is part of the matrix of legal concepts, principles, and lines of reasoning through which the legal system, as both dependent and independent variable, relates to the power structure and belief system of the economy. In adopting fundamental conceptions, such as the idea of the corporation as a person, the courts pro tanto define and legislate economic reality, determining the normative structure of the economy.’

The particularly complex question is the link between the law’s role as the definer of social and economic reality and the law’s role as ratifier of existing social and economic reality. Salomon’s recognition of the concept of the corporation as a legal person is formal reasoning with value and policy consequences which were not adequately addressed and which need to be fully aired and reconsidered.

A corporation is the legal personification of a firm which is a social institution. This legal personification should not distort the underlying social reality. Sir Samuel Griffiths CJ in Miles v Sydney Meat Preserving Co Ltd, an early case in the High Court, put it negatively in the following terms: ‘The law does not require the members of a company to … maintain the character of the company as a soulless and bowless thing, or to exact the last farthing in its commercial dealing or forbid them to carry on its operations in a way which they think conducive to the best interests of the community as a whole…’

To refer to Salomon’s principle in discussing corporate theory is simply to recognise it as a starting point for reasoning rather than a statement of comprehensive doctrine. A century after Salomon we need to address these questions about the nature of the corporation as a firm in society which the House of Lords failed to do in 1897. As Dean Roscoe Pound once said, ‘Law must be stable and yet it cannot stand still’.

Postscript

146 Ibid 124 et seq.
147 (1912-13) 16 CLR 50, 66.
This article represents themes which I have been developing for some time and which are reflected to some extent in my English company law book and earlier articles. At a late stage I have read the stimulating article by Michael Whincop ‘Overcoming Corporate Law. Instrumentalism, Pragmatism and the Separate Legal Entity Concept’ (1997) 15 C & SLJ 411. We have some ideas in common, particularly the view that Salomon was formal reasoning and is insufficient for doctrinal purposes, leading to contradictions in the law. Also we share the view that the contractarian analysis provides some insights. Our views seem to differ on other points. Nevertheless our articles can be usefully read together as part of an ongoing debate.\footnote{For recent discussions of stakeholder theories see the interesting papers by Sally Wheeler ‘Inclusive Communities and Dialogical Stakeholders’ a Methodology for Authentic Corporate Citizenship?’ (1998) 9 Aust Jnl of Corp Law 1 and Jennifer Hill ‘Public Beginnings, Private Ends – Should Corporate Law Privilege the Interests of Shareholders?’ (1998) 9 Aust Jnl of Corp Law 21.}