

THE COUNSEL



LAW STUDENTS' ASSOCIATION

University of Cross River State

Ikot-Osuruo Campus

Akwa Ibom State

THE CASE OF SALOMON V. SALOMON REVISITED

BY: BARRISTER ENEFIOK E. ESSIEN

The House of Lords decision in the justly celebrated case of *Salomon V. Salomon & Co. Ltd.* has been viewed variously as a "milestone in the development of company law, a "shocking" and a "calamitous" decision, and as a "boomerang". This paper sets out to critically examine the decision in the *Salomon* case and to assess the continued relevance of the case to present day Nigeria.

FACTS OF THE CASE:

Mr. Aron Salomon had for many years carried on a prosperous business as a leather merchant. He later converted his business into a limited liability company - *Salomon & Co. Ltd.* - which he formed for this purpose. He sold his business, then a going concern, to this new company for £39,000. In the new company he was Managing Director controlling share holder: of the 20,007 shares issued he held 20,001, and each of the remaining six shares was held by his wife and children, apparently as nominees for him. He paid for his shares by £20,000 cash and £10,000 in debentures. The debentures of £10,000 issued to Mr. Salomon were secured by creating a charge over all the Company's assets, thus making himself a preferred creditor in the event of the Company being wound up. The Company almost immediately ran into financial difficulties and went into liquidation. The assets of the Company were not enough to pay Salomon as a preferred creditor and then pay the unsecured creditors. The outside creditors therefore wanted to be paid first before Salomon.

ISSUES FOR DETERMINATION:

Since the cause of hardship to the outside creditors and the main reason for the dispute here was the creation of the floating charge, the main question before the Court therefore was whether or not the debentures originally taken by Salomon should be set aside in favour of these other creditors.

There was the ancillary question whether, where a trader, who is solvent, converts his business into a Limited Liability Company, and all the statutory

requirements for the Constitution of the Company are fulfilled, the Court is entitled to go behind the register and memorandum, and, upon a speculative analysis of motives and the exorbitance of price paid, to decide that the Company is not validly constituted on account of the non-fulfilment of conditions, ^{which} are not found in the Companies Act, such as a prohibition of blood relationship between the shareholders.

ARGUMENTS OF COUNSEL:

The arguments on both sides were very forceful. Farwell Q.C. for the respondent Company contended that the question was one rather of fact than law, and in such case the circumstances attending the incorporation of the Company must be considered; that although the literal requirements of the Statute may have been complied with, the Court was not precluded from getting at the real facts. He contended further that Salomon incorporated the Company so as to carry on his business without risk to himself and at his creditors' expense.

To this, Cohen Q.C. and Buckley Q.C. for Salomon replied that the question was rather one of law, and that there can be no objection if a vendor desires to convert his unlimited into a limited liability company, and that in fact this was the basic essence of the 1862 Act, namely, to encourage and enable unlimited liability companies get incorporation.

Farwell Q.C. argued secondly, that Salomon took the debentures so as to get advantage over creditors. Cohen Q.C. and Buckley Q.C. replied that it made no difference to the creditors whether debentures were held by the vendor or by strangers, since whoever held them had preference over creditors.

Farwell's third argument was that the sale was a fiction, that the purchase money was exorbitant, dictated solely by Salomon himself, and that Salomon concealed from the creditors the fact that the business was decaying when the Company was formed. Buckley and Cohen Q.Cs. replied that the sale of the business was bona fide: the business was genuine and solvent, with substantial surplus. All the circumstances were known to and approved by the shareholders. All the requirements of the Companies Act 1862 were strictly complied with.

The fourth argument put forward by Farwell Q.C. was that though incorporated under the Acts, the Company never had an independent existence: it was in fact Salomon under another name; he was the Managing Director, the other Creditors being his sons and under his control, in other words, were dummies; that the shareholders other than himself were own family, and his vast preponderance of shares made him master. He could pass any resolution, and he would receive all the profits, if any. Buckley Q.C. and Cohen Q.C. replied that the 1862 Act does not say that shareholders must not be related to each other, or that they must hold more than one share each.

Fifthly, it was Farwell's submission that Salomon defrauded the creditors by concealing from them the true state of facts of the Company. Cohen and Buckley replied that there was no misrepresentation of fact or "fraud upon creditors", since the creditors were under no obligation to trust the Company; they might, if they had desired, have found out who held the shares and in what proportion, and who held the debentures.

Farwell's sixth contention was that the Company was the "mere nominee and agent" of Salomon. Cohen and Buckley rejoined that there was no evidence to support this so as to make Salomon liable to indemnify the Company against its creditors.

The final argument by Farwell Q.C. was that the Company was Salomon's trustee and therefore merely had all the property and profits for the benefit of Salomon, and that the Company was a mere sham and fraud, in effect entirely contrary to the intent and meaning of the Companies Act. Buckley and Cohen replied on the issue of trust that there was nothing to prevent one shareholder or all the shareholders holding the shares in trust for some one person; that what was prohibited was the entry of a trust on the register, and that if all the shares were held in trust, that would not make the Company a trustee.

JUDGEMENT OF THE COURT:

The Judge of first instance, Vaughan Williams J., held that the "one man" (i.e. Mr. Aron Salomon) who had incorporated his business into a wholly owned and controlled company was the principal and the company was his agent, and that he must therefore

indemnify the company against the claims which the ordinary creditors advanced against the Company. Salomon was dissatisfied and so he appealed.

The Court of Appeal likewise held that the "one man" was identical with his company, but the court did not accept the principal and agency construction of the trial Court, and held that the formation of the Company and the issue of debentures in favour of the one man were a mere scheme to enable him to avoid liability to his creditors "contrary to the true intent and meaning of the Companies Act 1862". Again, Mr. Salomon appealed.

The House of Lords rejected the view taken by the Lower Courts and held that the "one man" and the company controlled by him were separated legal entities, and that the debentures issued in favour of the "one man" need not give precedence to the other debts of the Company.

It may well be necessary to deal elaborately on the judgment of the House of Lords so as to bring out the Principles of Company Law laid down or eloquently articulated in the case, most of which have, till today, formed the bases of Company Law.

On the contention that Salomon formed the company and sold his business to it so as to escape personal financial risk, the House of Lords, upholding the submissions of Buckley and Cohen Q.Cs. on this point, held per Lord Halsbury, L.C., that the motives of becoming shareholders or of making people shareholders is not a field of enquiry required by the Statute (i.e. the 1862 Act), and that if they were shareholders they were shareholders for all purposes.

On the contention that the other shareholders were nominal, holding only one share each, and that at any rate they were all the family of Salomon, the House of Lords again upheld the reply of Cohen and Buckley Q.Cs. The Court held that the Statute enacted nothing as to the extent or degree of interest which may be held by each of the seven, or as to the proportion of interest or influence possessed by one or the majority of the shareholders over the others. One share was enough. Lord Watson added thus:

“S.6 provides that any seven or more person, associated for a lawful purposes, such as the manufacture and sale of boots, may, by subscribing their names to a Memorandum of Association and otherwise complying with the provisions of the Act in respect of registration, form a company with or without Limited Liability; and Section 8 which prescribes the essentials of the Memorandum in the case of a Company Limited by share, inter alia, enacts that ‘no subscriber shall take less than one

The law Lord then added that the first of these enactments does not require that the persons subscribing shall not be related to each other; and the second plainly imports that the holding of a single share affords a sufficient qualification for memberships. Thus, any seven persons may form the Company: they need not be independent and beneficially interested. Lord Macnaghten put it more clearly thus:

“Once the provisions of the 1862 Companies Act are complied with it does not matter if the signatories are relations or strangers. There is nothing in the Act requiring that the subscribers to the Memorandum should be independent or unconnected, or that they or any one of them should take a substantial interest in the undertaking, or that they should have a mind and will of their own, or that there should be anything like a balance of power in the Constitution of the Company”.

On the issue of exorbitance of the price of the business which was sold by Salomon to the Company and of fraud, the House of Lords held that the Company formed by Salomon was not defrauded into the purchase of Salomon's business because, even if the price was exorbitant, all the shareholders were perfectly cognisant of the conditions under which the Company was formed and the conditions of the purchase. The Court referred to Erlanger V. New Sombrero Phosphate Co.² where it was laid down that persons who purchase property and then create a company to purchase from them the property they possess, stand in a fiduciary position towards that Company, and must faithfully state to the Company

2. (188

2. (1878) 3 App. Cas. 1281.

the facts which apply to the property, and would influence the Company in deciding on the reasonableness of acquiring it. Lord Halsbury noted that in Salomon's case every member of the Company, every shareholder, knew what was the true state of the facts.

On the question of the six shareholders holding their shares in trust for Salomon, the House of Lords held that if six of the seven shareholders were cestuis que trust of the seventh whatever might be their inter se, the Statute would have made them shareholders to all intents and purposes with their respective rights and liabilities.

And on the related issue of the Company itself being trustee for or agent of Salomon, Lord Macnaghten said:

“The company is at law a different person altogether from the subscribers to the memorandum; and, though 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 the subscribers as members liable in any shape or form, except to the extent and in the manner provided by the Act”.

The Court thereby, by this last holding, stated clearly and succinctly the principle of separate legal entity or the corporate personality of incorporated joint stock companies.

CRITIQUE:

The recognition of the Legal personality of the Company is clearly its most important feature in Law. This elementary and obvious principle is normally referred to as the rule in Salomon V. Salomon Co.Ltd. where this rule was applied in the circumstances shown above.

It must be stated, however, that the importance of the rule in Salomon V. Salomon has often been exaggerated. It has been thought that the case laid down the proposition that in any circumstances a shareholder who controls a wholly owned Company must be regarded as an entirely different legal person from that of his Company. This exaggeration can be

blamed on the House of Lords in the strict manner it couched the rule in Salomon's case. In reversing the Lower Courts, the House of Lords was rather too sweeping in stating what of course is good law, that the incorporated company is not an agent of its controlling or sole shareholder; it is an entirely different legal person. The Court ought to have made exceptions to this rule, for there are circumstances when an incorporated company may be agent of either its controlling shareholder or of a holding company. An interesting case in this connection is Smith, Stone & Knight V. Birmingham Corporation.³ Here the question was whether a holding company whose wholly owned subsidiary carried on a business on a piece of land could claim compensation when the land was compulsorily acquired by the corporation. The defence was the Salomon Principle, i.e., that only the subsidiary, and not the holding company, was entitled to the compensation. Atkinson J. rejected this defence, holding that the subsidiary was the agent or employee or tool or simulacrum of the holding company, and so the business belonged to the claimants who were therefore the real occupiers of the premises.⁴

In fact even Nigerian Courts have always recognised agency as an exception to the Salomon V. Salomon Principle. A recent Nigerian case in this regard is Mariner Nominees Ltd. V. FBIR.⁵

Again, it would appear that the decision in Salomon V. Salomon paid too much respect to form at the expense of substance, in so far as all it required was compliance with the literal wordings of the Companies Act as concerns the number of shareholders without caring who the members were. It makes good sense to argue that if the Act had intended the six members to be mere dummies it would just have stipulated that one person could form a company since dummies would serve no purpose. But since it required seven persons, it is submitted that all the seven persons should be real persons with a mind and will of their own. This is the only interpretation that could have effectuated the intendment of the Act. In this regard the French Company Law practice is to be appreciated. In France, Companies formed by one man with the help of nominees or - as they are colourfully described - "men of straw" - are considered as "fictitious companies" and are not validly incorporated. French legal theory holds that

3. (1939) 4 A E R 116.

legal personality does not result from merely performing certain acts which have been prescribed by law. Forms alone achieve nothing, unless they correspond to reality. It is hereby strongly urged that common law should take a cue from civil law - more especially the French practice.

A third problem with the decision in Salomon V. Salomon appears to be that all the Courts, from the High Court to the House of Lords, failed or refused to consider the issue of undercapitalisation. It may well be that if the Court had considered this point Mr. Salomon, who was the controlling shareholder, would have been held responsible for the debts of the company ruled by him. Counsel for the Company, Farwell Q.C., had argued that Mr. Salomon's sale of the business was a fiction; that there was no bargain, the sale was at the Vendor's own price, which was exorbitant, and such as no rational person would have paid. The House of Lords did not consider the issue of exorbitance; it merely said evasively that even if the price was exorbitant, all the shareholders were perfectly cognisant of the conditions of the purchase.

4. See also: Wallersteiner V. Moir (No.2) (1975) Q.B. 373. But perhaps the best illustration of the application of the agency construction is Re F.G. (Films) 1 AER 615.
5. (1986) 2 NWLR (Pt.20) 48. c.f.: Akande V Ornisade & 3 Ors. (1978) N.C.L.R. 363 where the Court said at page 371 that "the principle enunciated in Salomon V. Salomon & Co. Ltd. is sacrosanct".

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Here again it may be useful to have an excursion to the Continent. Under West German Law, for instance, a Sole controlling shareholder is responsible for the debts of the company ruled by him where the court finds out that there was under-capitalisation⁷ It often happens that less scrupulous promoters employ a company with a small capital for the purpose of carrying on a larger enterprise.

Such capital as the Company needs is provided by loans from the sole or controlling shareholder as in Salomon's case. Thus, as stated by Cohn and Simitis,⁸ in one case A had formed the X Company with the assistance of E and G, whose shares he purchased shortly after the formation of the Company. The Company's capital amounted to DM20,000 only. It

was utterly insufficient for the Company's business, but A provided further capital by way of loans which he gave to the Company. When things began to look bad, the Company repaid the loans to A. As a result its other creditors were unable to obtain repayment of their debts. They asked the Courts for an order that A should repay to the company the loans which he had given. They were successful. The loans, it was held, were to be treated as if they were the company's capital. The sole controlling shareholder who had started the company in this manner had to be treated as if the loan capital was share capital. He was under an obligation to repay the amount of the loans to the Company.

This German situation is in many ways similar to that in *Salomon V. Salomon*. But the German court, sitting in the 20th century, refused to be impressed by the *Salomon* principle; it realised that an acceptance of the *Salomon* principle would have enabled the sole controlling shareholder to withdraw the loan capital of the Company thus leaving the Company undercapitalised and the creditors helpless. In fact even in *Salomon V. Salomon* itself, the £10,000 which Mr. Salomon paid in debenture was part of the Company's capital because it was part of his payment for his 30,000 shares.

However, the 1882 Companies Act under which *Salomon V. Salomon* was decided has no stipulation for minimum capital. Perhaps that is why the Court did not consider the effect of undercapitalisation. In Nigeria the Company Law Review Commission⁹ has recommended ₦10,000.00 minimum share capital for private company and 1 million naira minimum for public company.¹⁰ It also recommends that a reduction of share capital below the legal minimum should not be confirmed by the Court.¹¹ Before recommending minimum capital the commission noted that one of the complaints about company formation in this country is that by far the largest proportion of them were not intended to run any serious business. They are not capitalised, and after incorporation, perhaps to win a contract which it does not intend to perform or to obtain an import licence for sale, the Company is forgotten and another is later formed for a similar purpose. Indeed, in many of these companies, there are two subscribers who take one share each and no further shares are issued with the result that all the issued and paid-up capital is only two naira.¹³

The principle in Salomon V. Salomon while allowing the businessman get the advantages of incorporation, also saddles him with disadvantages. It is in this wise that the principle can be described as a boomerang. Thus the owner of business who converts it into a company creates a legal person to which he himself owes duties which he cannot breach by treating himself as the real company.¹⁴ For this reason, a judgment of the individual cannot garnished debts owing to the Company.¹⁵ Also, owners and sole directors and managers of a company cannot decline to join the relevant trade union on the ground that they, by virtue of their position in the company, are employers,¹⁶ because they are in fact employees. In deed they employ no one as everyone is employed by the Company.¹⁷

Taken all in all, the importance and continued relevance of Salomon V. Salomon and its influence on modern company law cannot be gainsaid. The case eloquently articulates the principle of corporate personality which is still the conner-stone of company law even today. Many qualifications, both statutory and judicial have been made to rule, but it is still the rule and rule without which company law cannot operate. The case reiterates the duty of disclosure by company promoters which was earlier laid down by Section .29 of the 1844 Registration Act. It states clearly the law 'that

preferred payment must be made even to shareholders so long as they are secured creditors (debenture holders) outsiders may, if they like, check the books of the Company before investing in it: they are slapped with constructive notice. The case also laid down that share holders may be just nominal, with no beneficial interest, and that all or any of the shareholders may be blood relations. It further laid down that the "one-man" company does not, without more, qualify as an abuse of corporate form. All said, the case is a milestone in the development of company law. The decision has been criticised as calamitous,¹⁸ and shocking¹⁹ This writer is however inclined to the view that these criticisms are against the decision in Salomon V. Salomon and not against the principles of Law established in that case. This is moreso because the principles therein established have been upheld and applied in a plethora of cases.

Court said at page 371 that "the principle enunciated in Salomon V. Salomon & Co. Ltd. is sacrosanct". Quære: was the Court saying that the principle is inviolate and without exceptions?

6. See Cohn & Simitis (1963) 12 I.C.L.Q. 189 at 209.

7. (1963) 12 I.C.L.Q. 189 at 191.

8. Ibid.

Ibid.

9. The Commission met in Lagos in February 1988.

10. See Nigerian Company Law Review Committee Recommendations Vol. 1, p. 83.

11. Ibid, at p. 86.

12. Ibid, at p. 42.

13. See, e.g., BORNU HOLDING & CO. V. DIPCHARIMA (1976) 1 SC. 63.
14. See Romer, L.J., Re Harmer Ltd. (1958) 3All E.R. 689.
15. See Banque de L'Afriguw Occidentale V. Habu (1964) N.N.L.R. 30; Aiyetoro Community Trading Co. Ltd. V. Marine Factors (Nig) Ltd. (unreported Lagos H. Ct. Suit No. LD/4A/70 of 4th November, 1970).
16. Boulting V. A.C.T.A.T. (1963) 2 Q.B. 606.
17. Per Upjohn, L.J.P. 634; See also A.R.E.C.V. Amaye (1986) 3 N.W.L.R. (pt. 31).
18. Kahn-Freund, "Some Reflections on Company Law Reform" (1944) 7 M.L.R. 54
19. Gower, Company Law 3rd ed. P. 70.