"ONE MAN COMPANIES" AND THEIR CONTROLLING SHAREHOLDERS

Three recent cases respecting the legal relations between a "one man company" and its controlling shareholder invite a review of the general principle of corporate entity and its corollaries. The cases are: *Patton et al.* v. *Yukon Consolidated Gold Corporation Ltd.*,[1] *The Export Brewing and Malting Co. Ltd.* v. *The Dominion Bank*,[2] and *Dominion Royalty Corporation et al.* v. *Goffatt*.[3]

In each of these cases the court was invited to pass beyond the line which separates the company as an artificial person from the individual shareholder who controls it, and to declare the company to be a sham, simulacrum, or cloak for the controlling shareholder.

The leading case laying down the fundamental principle is *Salomon* v. *Salomon and Company, Limited*.[4] In that case the facts were that one Salomon, a leather merchant, was the owner of a profitable business, and in order to obtain the advantages of limited liability, he being perfectly solvent at the time, converted the business into a private joint stock company. Of the shares in the authorized capital he himself took 20,000 and his wife, daughter and four sons each took one. No other shares were issued. Salomon received also mortgage debentures for £10,000 in part payment for the business.

The company became insolvent and went into compulsory liquidation. Unsecured creditors' claims aggregated more than seven thousand pounds, and if Salomon's debentures were valid there was nothing left for unsecured creditors. It was the validity of these debentures which was questioned in the action on the ground that the company was a one-man company and a sham. Vaughan Williams J. as trial judge, and the Court of Appeal (Lindley, Lopes, and Kay L. JJ.) held that the formation of the company and the issue to Salomon of the debentures was a mere scheme. Judgment was therefore granted rescinding the original transfer from Salomon to the company, ordering the debentures to be delivered up and cancelled, and Salomon was held personally liable for all sums paid to him by the company. In addition, the company was given a lien on all sums payable

[1] [1934] O.W.N. 321; [1934] 3 D.L.R. 403.
[2] [1934] O.R. 560.
[3] [1935] O.R. 169. Affirmed on appeal to the Supreme Court of Canada, [1935] S.C.R. 535.
[4] [1897] A.C. 22.

to Salomon in respect of his debentures. This decision was unanimously reversed by the House of Lords, and in the course of his speech, Lord Herschell said:[5]

> It is to be observed that both Courts treated the Company as a legal entity distinct from Salomon and the then members who composed it, and therefore as a validly constituted corporation. This is, indeed, necessarily involved in the judgment which declared that the company was entitled to certain rights as against Salomon. Under these circumstances, I am at a loss to understand what is meant by saying that A. Salomon & Co., Limited, is but an "alias" for A. Salomon. It is not another name for the same person; the company is ex hypothesi a distinct legal persona. As little am I able to adopt the view that the company was the agent of Salomon to carry on his business for him. In a popular sense, a company may in every case be said to carry on business for and on behalf of its shareholders; but this certainly does not in point of law constitute the relation of principal and agent between them or render the shareholders liable to indemnify the company against the debts which it incurs.

In *Daimler Company, Limited* v. *Continental Tyre and Rubber Company (Great Britain) Limited*,[6] the question was touched upon by Lord Parker when he said:

> In questions of property and capacity, of acts done and rights acquired or liabilities assumed thereby it may be always true (that the personalities of the natural persons who are its corporators are to be ignored). Certainly it is so for the most part.

The question was further discussed by Lord Justice Younger (now Lord Blanesburgh) in the *Rainham Case*,[7] where, in discussing the alleged personal liability of certain individual defendants who were the sole owners and controllers of the defendant company, he said:

> Liability was suggested on several grounds, First of all, this governing passage in Lord Justice Scrutton's judgment was relied on: "The truth is, the agreements were paper shams, and made no difference to the reality. The persons who controlled the business before, controlled it after the agreement. The persons who found the money before, found it after the agreement. But if there was any reality in the arrangement at the time of the explosion the company was there carrying on business as agent for Partridge and Feldman by the express terms of the agreement. I answer, therefore, the question: Who was carrying on this dangerous business so as to be liable under the doctrine of *Rylands* v. *Fletcher*, L.R. 3 H.L. 330, for damage done by it, by saying that Feldman and Partridge were carrying it on as principals, and the company as their agent, Feldman and Partridge being also Governing Directors of the Company in complete control of the business."

[5] At p. 42.
[6] [1916] 2 A.C. 307.
[7] *Belvedere Fish Guano Company, Limited* v. *Rainham Chemical Works, Limited*, [1920] 2 K.B. 487 at p. 516.

> Now I am not certain myself that I fully appreciate the Lord Justice's reasoning in that passage. If the agreements were paper shams, I do not quite understand how the company enters into the matter at all, yet judgment was given against it—nor do I understand how these appellants are principals and not owners. Nor again, if the agreements are shams, do I understand how the relations between the parties to them can be fixed by any clause contained in them.

And he holds that it is clear that in no sense was the company an *alter ego* or agent of the individual appellants.

The case was appealed to the House of Lords and in the course of his speech, Lord Parmoor says:[8]

> I agree with Younger L.J. that the company was not, at the date of the explosion, carrying on the manufacture of picric acid as agent for the appellants, and that in respect of the contract with the Ministry, the company did not act as the agent of the appellants.
>
> In order to determine whether, under the above conditions, the appellants are liable, it is essential that there should be no confusion of the grounds on which liability has been suggested. In the first place I think that the appellants cannot be held liable, either directly or indirectly, as governing directors of the company, and to hold them to be so liable would be inconsistent with established principles. The appellants, as governing directors, incurred no personal liability. Directors of a company, which has been bona fide established, cannot be regarded as principals for whom the company act as agents. Whatever may be the true meaning of the passages in the judgment of Scrutton L.J., to which reference has been made, there is no evidence that the company was a sham, or that the relationship between the directors and the company was either abnormal, or based on a sham procedure.

This view appears to have received the concurrence of the other members of the court, though the individual defendants were held liable under *Rylands* v. *Fletcher* as possessing a right of legal occupancy of the lands.

Again in *Commissioners of Inland Revenue* v. *Sansom*,[9] Lord Justice Younger says:[10]

> Now, speaking for myself, I do in the light of these considerations, deprecate in connection with what are called one-man companies the too indiscriminate use of such words as simulacrum, sham, or cloak—the terms found in this case—or indeed any other term of polite invective. Not only do these companies exist under the sanction, even with the encouragement of the Legislature, but I have no reason whatever to doubt that the great majority of them are as bona fide and genuine as in a business sense they are convenient and suitable media for the provision and application of capital to industry.

[8] [1921] 2 A.C. 465 at p. 488.
[9] [1921] 2 K.B. 492.
[10] At p. 514.

> No doubt there are amongst such companies, as amongst any other kind of association, black sheep; but in my judgment such terms of reproach as I have alluded to should be strictly reserved for those of them and of their directors who are shown to deserve condemnation, and I am quite satisfied that the indiscriminate use of such terms as, not infrequently, led to results which were unfortunate and unjust, and in my judgment this is no case for their use.

In *British Thomson-Houston Company, Limited* v. *Sterling Accessories, Limited*,[11] Tomlin, J. (afterwards Lord Tomlin) says:

> It has been made plain by the House of Lords that for the purpose of establishing contractual liability it is not possible, even in the case of the so-called one man company to go behind the legal corporate entity of the company and treat the creator and controller of the company as the real contractor merely because he is the creator and controller . . . . . Nor does the matter stand otherwise in regard to liability for tortious acts.

He then quotes Lord Buckmaster in the *Rainahm Case*,[12] where he points out that the Companies Acts expressly contemplate that people may substitute the limited liability of a company for the unlimited liability of the individual *with the object that by this means enterprise and adventure may be encouraged.*

The *Salomon Case* was reported in 1897, and in 1899 the principle there enunciated was adopted and applied by the Court of Appeal for Ontario in the case of *Rielle* v. *Reid*,[13] where the judgment of the trial judge who sought to distinguish the *Salomon Case* and to maintain the "alias" view, was reversed. From that time till now no dissent from the doctrine is to be found in the Federal or in the Provincial courts of Canada. The result seems to be that it may now be taken as a settled principle, which has been jealously maintained, that the legal persona created by incorporation is an entity distinct from its shareholders and directors and even in the case of a one-man company that the company is not an alias for the owner of all the shares.[14]

Such being the general principle and the reasons on which it is founded it becomes interesting to examine how far, if at all, certain other cases tend to limit or qualify the doctrine so expressed.

In *Daimler Company, Limited* v. *Continental Tyre and Rubber Company (Great Britain) Limited*,[15] the Continental Company

[11] [1924] 2 ch. 33.
[12] [1921] 2 A.C. 465 at p. 475.
[13] 26 O.A.R. 54.
[14] In addition to the cases previously cited, see *Kodak, Limited* v. *Clark* [1902] 2 K.B. 450; [1903] 1 K.B. 505; *Janson* v. *Driefontein Consolidated Mines, Limited*, [1902] A.C. 484 at pp. 497, 498, 501.
[15] [1916] 2 A.C. 307.

during the Great War issued a specially indorsed writ against the Daimler Company for a trade debt. The Continental Company was incorporated in England, but all its shares except one were owned by German individuals and a German company. One share was owned by the secretary of the company who had been born in Germany but had become a naturalized subject of the British Crown. All the directors were German. The Continental Company moved summarily for judgment and the Daimler Company raised the defence that notwithstanding the circumstance that the plaintiff company was incorporated in England, it was nevertheless an alien enemy incapable of maintaining an action in the courts of His Majesty.

The Court of Appeal held that the action by the company was maintainable because the Continental Company was a British entity distinct from its German shareholders and directors. This judgment was unanimously reversed by the House of Lords. Lord Parker of Waddington speaking for himself, Lord Sumner and two other law lords, said:[16]

> What is involved in the decision of the Court of Appeal is that, for all purposes to which the character and not merely the rights and powers of an artificial person are material, the personalities of the natural persons, who are its corporators, are to be ignored. An impassable line is drawn between the one person and the others. When the law is concerned with the artificial person, it is to know nothing of the natural persons who constitute and control it. In questions of property and capacity, of acts done and rights acquired or liabilities assumed thereby, this may be always true. Certainly it is so for the most part. But the character in which property is held, and the character in which the capacity to act is enjoyed and acts are done, are not in pari materia. The latter character is a quality of the company itself, and conditions its capacities and its acts. It is not a mere part of its energies or acquisitions, and if that character must be derivable not from the circumstances of its incorporation, which arises once for all, but from qualities of enmity and amity, which are dependent on the chances of peace or war and are attributable only to human beings, I know not from what human beings that character should be derived, in cases where the active conduct of the company's officers has not already decided the matter, if resort is not to be had to the predominant character of its shareholders and corporators.

Stated in a form perhaps less accurate it would seem that this passage means something like the following.

It is an implied condition of the exercise of the power to sue in His Majesty's courts which is conferred on a company by its incorporation that individuals who exclusively promote and

[16] At p. 340.

direct its activities shall not themselves be under a disability to sue.

Lord Atkinson and Lord Shaw, while not agreeing with this view, concurred in allowing the appeal because of a lack of any capacity in the secretary or his directors to institute the action or direct the issue of the writ. The result appears to be that the question determined in this action lay outside the scope of the *Salomon Case*, and is not at variance with the principle there stated when applied to the holding of property by the company or to its capacity in contract or in tort.

It should be observed, however, that Lord Halsbury in his judgment emphasizes the point that "the unlawfulness of trading with the enemy cannot be excused by the ingenuity of the means adopted," and he adds that "the mere machinery to do an illegal act will not purge its illegality—fraus circuitu non purgatur."[17] This agrees with the observation of Lord Buckmaster in the *Rainham Case*,[18] where, referring to the views that had been expressed in the Court of Appeal[19] by the Master of the Rolls and by Atkin L.J., he said:

> I cannot accept either of these views. If the company was really trading independently on its own account, the fact that it was directed by Messrs. Feldman and Partridge would not render them responsible for its tortious acts, unless, indeed, they were acts expressly directed by them. If a company is formed for the express purpose of doing a wrongful act or if, when formed, those in control expressly direct that a wrongful thing be done, the individuals as well as the company are responsible for the consequences, but there is no evidence in the present case to establish liability under either of these heads.

It remains to consider the question whether the company stands in the relation of agent to the person or persons who own a controlling or the entire interest in its shares.

If that is the only evidence the answer is no, but as was said by Cozens Hardy M.R. in *The Gramophone and Typewriter, Limited* v. *Stanley*,[20] "I do not doubt that a person in that position may cause such an arrangement to be entered into between himself and the company as will suffice to constitute the company his agent for the purpose of carrying on the business." Cases where such a relationship is established are rare, because one of the objects usually sought through incorporation of a company is to relieve the corporators from personal

[17] At p. 316.
[18] [1921] 2 A.C. at p. 476.
[19] [1920] 2 K.B. 487.
[20] [1908] 2 K.B. 89 at p. 96.

liability. It becomes in every case a question of fact whether the relationship of principal and agent is established. Such a relationship was established in the case of *Apthorpe* v. *Peter Schoenhofen Brewery Company*.[21] Proof that the controlling operator holds all the shares of the company and is the managing director is insufficient.[22]

The three Ontario cases mentioned above illustrate the importance of avoiding confusion respecting the grounds of liability either of the company or of its corporators.

In *Patton et al.* v. *Yukon Consolidated Gold Corporation and Treadgold*,[23] the action was brought by Patton and others on behalf of themselves and all other shareholders except Treadgold against the Yukon Company and against Treadgold and the Forke Company for surrender by Treadgold and for cancellation of certain shares in the Yukon Company which Treadgold had, as the court found, secretly acquired without the contribution of money or moneys worth, in the course of his re-organization of the Yukon Company. The court also found that Treadgold had been for years a director of the Yukon Company in control of the management of its affairs, and he was found by the court to be a promoter of the re-organization scheme under consideration. He stood in a fiduciary relationship to the shareholders of the Yukon Company and to his co-directors and had failed to make to them the full disclosure which the law requires in such circumstances.

Treadgold sought to justify this action because the actual vendor to the reorganized company was the Forke Company—a "one-man company" all the shares of which were owned or controlled by him. He relied on the *Salomon Case*, and claimed that the Forke Company was an entity distinct from himself and acted in its corporate capacity as such in the transactions in question, and not as an alias for Treadgold.

He frankly admitted that the Forke Company, all of whose shares he owned or controlled, was his financial instrument employed by him for the accomplishment of the object which was attacked by the plaintiffs.

The facts as found by the trial Judge and confirmed by the Court of Appeal, are that the Forke Company was employed

[21] (1899), 15 T.L.R. 245.

[22] *British Thomson-Houston Company, Limited* v. *Sterling Accessories, Limited*, [1924] 2 Ch. 33 at p. 38. The question is also touched upon in the *Rainham Case*, [1921] 2 A.C. at pp. 475 and 488; *The Gramophone Case, supra; Performing Rights Society* v. *Sibyl Theatrical Syndicate*, [1924] 1 K.B. at p. 14.

[23] [1934] O.W.N. 321; [1934] 3 D.L.R. 403.

by Treadgold as vendor in name, to accomplish an unlawful purpose, *viz.*, to obtain for himself an advantage contrary to law. Also that it was clearly Treadgold's agent and consequently that the *Salomon Case* did not protect him from personal liability.

In *Export Brewing and Malting Co. Ltd.* v. *The Dominion Bank*,[24] the plaintiff sued to recover certain bonds held by the Bank as collateral security. Burns, Leon & Low were the actual owners of the capital stock of the plaintiff company, though their wives held one share each to complete the organization. The bonds in question were pledged by the company to the Bank primarily to secure the Bank against a guarantee given to the Crown by the Bank on behalf of the company, and secondarily as collateral security for a very large individual indebtedness of Burns, Leon & Low to the Bank.

The plaintiff's contention, among other, was that the hypothecation agreement in question, so far as it related to Burns, Leon & Low, was not binding on the company in that it was to the knowledge of the Bank a fraudulent transaction for the benefit of the individual directors who caused it to be executed, without consideration to the plaintiff company. The determination of the Court was unanimously in favour of the bank but for differing reasons.

A minority view was that the Company was "a sham, simulacrum, or cloak," and that its business must be regarded as the business of its corporators, Burns, Leon & Low. The judgment of the majority held that the company was an entity distinct from its shareholders and that the onus was on the plaintiff to establish its contention as stated above, which onus had not been satisfied. Also that in the situation as it was found to exist, it was for the company itself to determine whether or not this pledge of bonds to the bank was or was not in the interest, direct or indirect, of the company. The judgment also went on to point out the likelihood of injustice that may arise from the indiscriminate use of such terms as "alter ego," "sham," and the like.

While the third case, *Dominion Royalty Corporation* v. *Goffat*,[25] ultimately fell to be determined on an issue irrelevant to the question here under consideration, yet it affords a further illustration of the rule that the employment of a one man company as a cover for an unlawful purpose will not shield the controlling individual corporator from liability.

[24] [1934] O.R. 560.
[25] [1935] O.R. 169; affirmed in [1935] S.C.R. 565.

The conclusions to be deduced from the foregoing cases appear to be as follows:

1. In questions of property and capacity, of acts done and rights acquired or liabilites assumed, the company is always an entity distinct from its corporators. It is not an alias or a sham, and the principle of the *Salomon Case* stands unimpaired.

2. For the purpose of determining the conditions on which the capacity to act is enjoyed and acts are done by the company, the personalities of the natural persons who are its corporators and the predominant character of its shareholders and corporators are open for consideration.

3. If a company is formed for the express purpose of doing a wrongful act, or if when formed those in control expressly direct a wrongful thing to be done, the individuals as well as the company are responsible. The mere machinery to do an illegal act will not purge its illegality.

4. Whether an individual has constituted the company his agent is a question of fact, but the fact that the controlling corporator holds a majority or even the whole of the shares and is the managing director will not alone suffice to establish the relationship of principal and agent between himself and his company.

5. Where the evidence brings the case within rule 3, or where it establishes that the company is a mere agent of the controlling shareholder (rule 4), it may be appropriate to characterize the company as a paper sham, a simulacrum, cloak, *alias* or *alter ego*—but otherwise the indiscriminate use of these or similar terms is liable to lead to confusion of thought and possible injustice.

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