Universität Zürich[UZH]

Legal Personality and Limited Liability

Dr David Roth

Principles of Corporate Law

Fall Semester 2025

Lecture 2

L1. Shareholders supremacy model

- First priority («primacy») to shareholders:
  «There should be no confusion… A business corporation is organized and carried on primarily for the profit of the stockholders.» (*Dodge v. Ford Motor Co.*, 1919)
- Shareholders as «true owners» of the corporation (Berle & Means, 1932)
- Historical rationale? «member»/«owner» (guilds, partnersh.)
- Milton Friedman (1912-2006):
  Linking shareholder primacy and profit maximisation
  - «Corporations have no higher purpose than maximizing profits for their shareholders»
  - «[A] corporate executive is an employee of the owners of the business […] [T]he manager is the agent of the individuals who own the company […] and his primary responsibility is to them.»

L1. Four versions of shareholder primacy

1. Board and managers are accountable to shareholders only

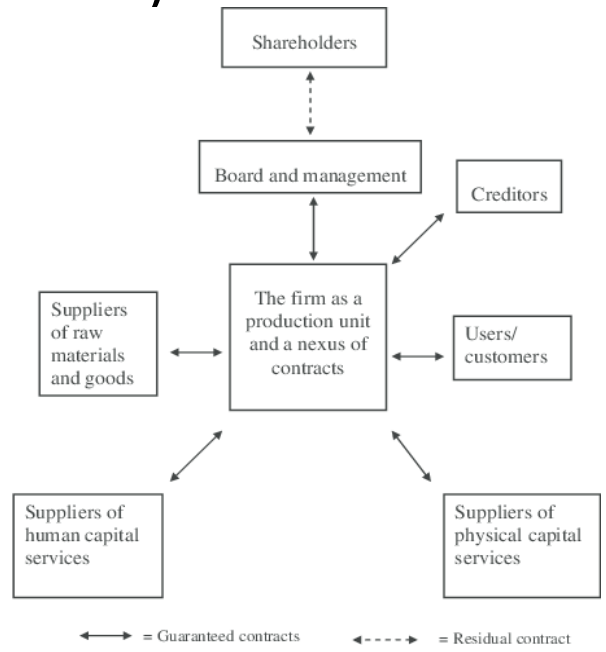
2. Shareholders have excluse right to elect directors and vote on company matters

3. Traditionally: Sole corporate objective is maximizing returns for shareholders

4. More recently: Companies are run according to shareholders' «wider» preferences (not just regarding financial returns but also social, political, environmental matters)

L1. Residual claimants model

- Shareholders have a superior position in corporation, but why?
- «Owners» of the corporation (-)
- Shareholders as residual claimants
  - Receive payment only after creditors (and other stakeholders) are paid → distribution rules, winding up rules
  - Last-in-line position may incentivise shareholders to act in the best interest of all stakeholders (! negative externalities)



L1. From shareholderism to stakeholderism

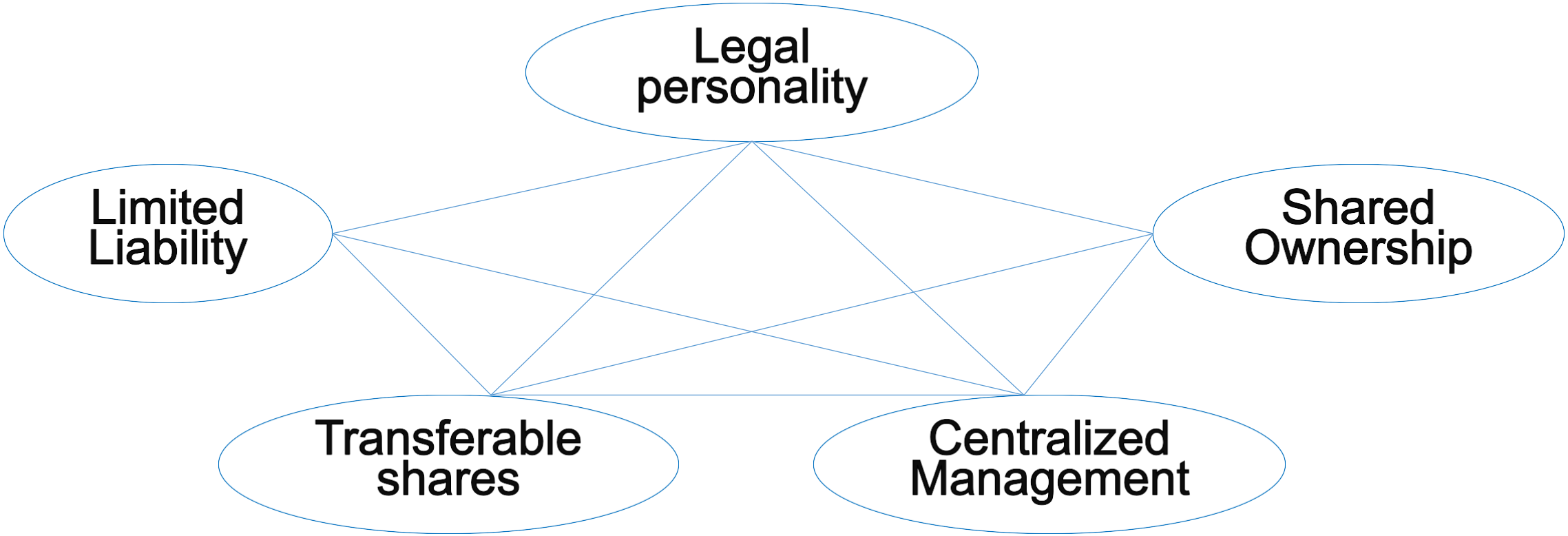
- Stakeholderism as an inclusive form of capitalism
- Stakeholders - Definitions
  - Wide: «Any group or individual who can affect, or is affected by, the achievement of a corporations purpose» (Prof R. Edward Freeman)
  - Narrower: Core constituencies of a company, such as customers, employees, suppliers, shareholders and debt creditors, and communities or the general public
- Addressees of the balancing dilemma: Directors, executives of the company
- Different practical implications depending on the version of stakeholderism (see next slide)

L1. Four versions of stakeholder capitalism

1. Instrumental – Managers should respect *stakeholders*' interests and in doing so will maximise long-term returns to *shareholders* (cf. Residual claimants model; 4th version of shareholder primacy)
2. Classic – Companies have ethical and legal obligations to stakeholders that must be respected whether or not doing so is likely to maximize shareholder value
3. Beneficial – The corporate objective is improving all stakeholders' well-being (rather than just maximizing value for shareholders)
4. Structural – To protect stakeholder interests, stakeholders other than shareholders should have formal powers in corporate governance

See further: Lynn S. Paine, *What does…*, Harv. Business Rev. Magazine 09/10, 2023

L1. Key attributes of a corporation



Lecture 2 – Overview

- Legal Personality
  - The corporation as a creation of law
  - Reasons to incorporate
  - Incorporation procedures
  - Effects of incorporation
- Limited Liability
  - Entity shielding and owner shilding
  - Substitute: legal capital
  - Piercing the corporate veil
  - Limited liability and corporate groups
  - A glance at the *societas europaea*

The corporation as a creation of law

«I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery in modern times. […] Even steam and electricity are far less important than the limited liability company, and they would be reduced to comparative impotence without it.»

(Nicolas Murray Butler, President Columbia University, 1911)

The corporation as a creation of law

- Roman law: *hereditas* as «personae vice fungitur»
- Gustav Hugo (1719-1791): «juristische Person» → legal person
- But what is a legal person:
  - A fiction? (Fiction theory; F.C. von Savigny et al.);
    Trustees of Dartmouth College v. Woodward (17 U.S. 518; 1819):
    «A corporation is an artifical being, invisible, intangible,
    and existing only in the contemplation of law.»
  - A «reality»? (Real entity theory; see above)

  → Consequences regarding legal capacity, capacity to act?
  (see below – functional approach)

Reasons to incorporate

- The corporation as a device for raising capital
  - Incorporation → Limited liability
  - Promoters (entrepreneurs) in search of capital
    - (Firms') demand and (investors') supply
    - Promotors use (other) shareholders' investments as a sort of «leverage»
  - Why provide capital?
  - No active participation
  - Risk-aversity → Diversification
  - Limitation of liability also provides for higher transferability of shares
- The corporation as a device for veiling ownership? (see next slide)

Beneficial owners

- Financial Action Taskforce (FATF, GAFI, housed at OECD)
  - 40 members, 200+ committing countries
  - Standard setting, identifying high-risk jurisdictions (grey and black lists)
- Aim: Reduce terrorist financing, money laundering, and other illicit practices
- Instrument: Identify beneficial owners of reporting companies (reporting oblig.)
- Implementation (by the example of [rev.] U.S. Corporate Transparency Act 2021)
  - «Reporting companies» need to report «beneficial owners» to Financial Crimes Enforcement Network (FinCEN)
  - «Benefial owners»: *Individuals* who, directly or indirectly, exercise «substantial control» (senior officer; having authority or substantial influence) or own at least 25 % stock
  - «Reporting companies»:
    - Until March 2025: Domestic and foreign companies active in U.S.
    - Since March 2025: Only foreign companies active in the U.S.; report only non-U.S. b.o.

Terminology: Public and private corporations

- Corporations with *freely tradable* shares: “open” or “public” corporations
- Corporations with *restrictions* on the tradability: “closed” or “private” corporations
- Two further distinctions:
  - Shares of open corporations *listed for trading on a stock exchange*:
    “listed” or “publicly traded” corporations, in contrast to an “unlisted” corporation.
    → “Publikumsgesellschaften”
  - Shares held by a small number of individuals whose interpersonal relationships are important to the management of the firm: “closely held” as opposed to “widely held"
- There are other uses, e.g. European System of Accounts (ESA95):
  “Public corporation” → controlled by government or other public corporation,
  “öffentliches Unternehmen” – we use the terminology above!

Incorporation procedures – Germany

- DE corporation: Aktiengesellschaft
- Articles of incorporation («Satzung») with mandatory contents
- Subscription to shares by incorporators → «corporation in formation»
- Appointment of supervisory board and auditors
- Notarised deed necessary for all three steps
- Supervisory board appoints management board (dualistic system)
- Application to court for registering in the commercial register
  - By incorporators, supervisory and management board
  - Court reviews articles
  - Registration → legal personality
- Comparison to CH

The Articles of Association (CH)

- “Statuten”
- Single governing document
- Mandatory content (Art. 626 Swiss Code of Obligations)
  - Name
  - Registered office
  - Objects
  - Share capital and amount of the contributions made
  - Number, nominal value and type of the shares
  - Convening the general meeting
  - Voting rights of shareholders
  - Board of directors and auditors
  - Form of communications issued by the company

Alterations (by the example of CH)

- Art. 703 CO: Principle
  → Amendment by absolute majority
- Art. 704 I CO: Important amendments – mandatory double hurdle:
  - Resolution with the consent of at least two thirds of represented votes
  - Absolute majority of the represented capital
- Art. 704 II CO: Higher quorums may be required
  → if provided so in the articles of association

Incorporation procedures – U.K.

- UK corporation: Public limited by shares companies
- «Articles of association» and «memorandum of association»
  - Companies Act 2006: New «constitutions» through articles only (sect. 17, 28)
  - Mandatory provisions, but
    no mandatory corporate object (despite art. 3[b] EU-Dir. 2017/1132)
- Filing with the Registrar of Companies
  - Review and issuance of a «certificate of incorporation»
  - Proof of paid-in capital and «trading certificate»
  - Registration → legal personality

Corporate object – U.K.

- Principle: The company has unlimited objects unless it is specifically stated that its objects remain restricted
- Amendment of the objects clause comes into effect only from the moment of the registration by the Registrar of Companies
- Company must act intra vires («within its powers»)
- Ultra vires («beyond its powers») doctrine
  - When a company acted beyond its purpose or powers
    - Restrained from using its funds for purposes other than the specified
    - Restrained from carrying on trade differend than the authorised
  - Imperfectly abolished by the Companies Act 2006
- Breach is a source of liability

Incorporation procedures – U.S.

- U.S. corporation: stock corporation
- State law → by the example of Delaware
- Certificate of incorporation
  - Few mandatory provisions, no notarisation
  - Statement about number of shares, their par value or that they are no par (see further below)
  - Filing with the «secretary of state», review for obvious errors
  - «Duly filed» → Legal personality

Liability of promoters and active shareholders

- Before completion of incorporation
  - Art. 7 para. 2 EU-Dir. 2017/1132:
    «If, before a company being formed has acquired legal personality, action has been carried out in its name and the company does not assume the obligations arising from such action, the persons who acted shall, without limit, be jointly and severally liable therefor, unless otherwise agreed." (emphasis added)
  - National implementations
  - Common law: Impossible to act as an agent for a non-existing principal (*Kelner v. Baxter*, LR 2 CP 174, 1866-67)
    → Acting person herself is bound by the agreement
- In case incorporation is defective
  - Unlikely if articles are reviewed thoroughly
  - Restrictions to nullity (definite list in art. 11[b] EU-Dir. 2017/1132):
    e.g. unlawful objects; results in orderly dissolution (winding-up)

Estoppel / venire contra factum proprium

- General principle of (Common and Civil) law:
  Nemo potest venire contra factum proprium
  (No one can come/act against their own acts)
- «It is called an estoppel or conclusion, because a man's own act or acceptance stoppeth or closeth up his mouth to allege or plead the truth»
  (2 Lord Coke, Littleton 352a)
- Example: Liability limitation of the acting person of a defective corporation if the counterparty knew about the defect

– B. Scope and limits of legal relationships

– I. Acting in good faith

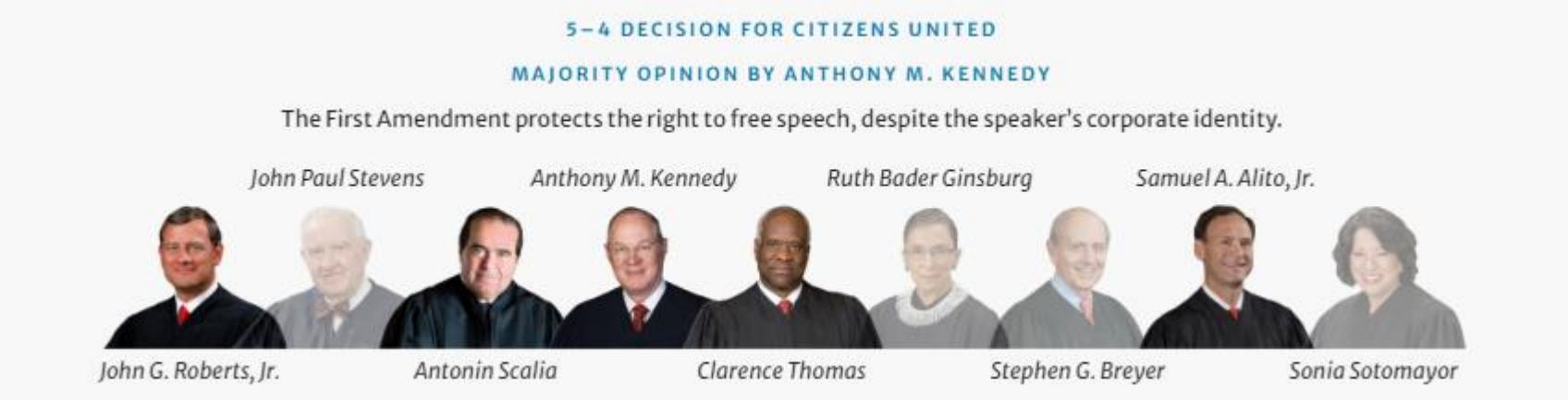
– Art. 2

[1] Every person must act in good faith in the exercise of his or her rights and in the performance of his or her obligations.

[2] The manifest abuse of a right is not protected by law.

Legal capacity

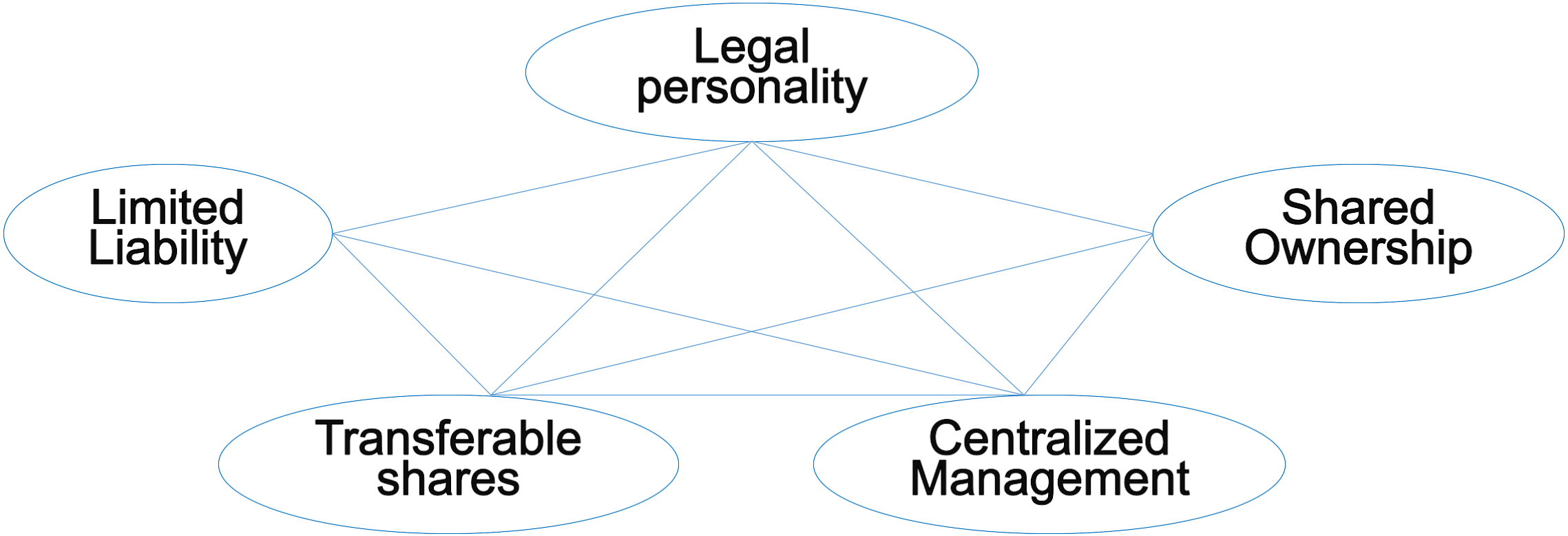
- Legal capacity: capacity to be a holder of rights and bearer of obligations
- Property rights
- Personal rights
  e.g. *Citizens United v. Federal Election Commission* (130 S.Ct. 876; 2010)
- Procedural rights (right to sue and be sued)



Capacity to act

- Capacity to act: capacity to establish rights and obligations through its own actions
- Legal persons act through their representatives/organs
  - Original competence
  - Competence through delegation
  - Factual (de facto) organs
- Contract
- Tort
- Crimes

Further effects of incorporation



Entity shielding and owner shielding

- Legal personality/«separate patrimony» and limited liability have a dual rationale:
  - Protecting the firm's assets from the shareholders and shareholders' creditors (in favour of the firm's creditors)
    → Priority and liquidation protection: (strong) entity shielding
  - Protecting the firm's shareholders from the firm's creditors (apart from the paid-in capital)
    → «Owner» shielding
- Result is two separate pools of assets:
  - Firm's assets (pledged as security to business creditors)
  - Shareholders' assets (reserved for shareholders' personal creditors)

Macaura v Northern Assurance Co. (1925)

- Mr Macaura sold all timber to a UK company (Irish Canadian Saw Mills Ltd) in which he and his nominees held all the shares.
- Mr Macaura insured the timber against fire on policies in his own name.
- After two weeks, a fire broke out, and Mr Macaura claimed the insurance.
- The insurance company Northern Assurance Co Ltd took the position that Mr Macaura did not have an insurable interest as a shareholder in the company. They argued that the company is a separate legal entity.
- Lord Sumner: “His relation was to the company, not to its goods”
- Lord Wrenbury: “The incorporator, even if he holds all the shares, is not the Corporation, and neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation”
- Lord Buckmaster: “The shareholders’ interest is limited to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus assets when it is wound up – whereas the interest of the company is in the property which it owns”

Substitute: Legal capital

- Substitute for *shareholders*' liability («owner shielding» function)
- Pool of asset which is reserved for creditors and committed to discharging obligations
  - Synonyms: «stated capital», «fixed capital»
  - No return of legal capital to shareholders in liquidation after all creditors have been paid
  - If legal capital has been reduced in trading, it must first be restored; moreover, some part of profits must be kept as reserves before payment to shareholders
- Statutory provision vs merit (reasonability) and/or disclosure approach
- Similar starting points on both sides of the Atlantic, deviating developments (see below)

Historic perspectives – U.S.

- *Wood v. Dummer* (Justice Story, 30 F.Cas. 435, 1824):
  «[T]he capital stock of banks is […] a pledge or trust-fund for the payment of the debts contracted by the bank. [S]tockholders have no rights until all other creditors are satisfied.»
- Par value of shares was seen as «security» and substitute for personal liability
  cf. Morawetz, *A Treatise on the Law of Private Corporations*, 1886.
- But (still today): No minimum capital requirements (e.g. Delaware)
- Par value has a second function: Protection against dilution of existing (minority) shareholders' vote and interest. But gradual erosion:
  - Most states authorised issuing shares with *no par* by 1912 and allowed corporations to exclude pre-emptive rights (proportionate acquisition rights)
  - *Handley v. Stutz* (139 U.S. 417, 1891): shares below par in case of financial emergency

Historic perspectives – Europe (before EC Dir.)

- France (concession → general incorporation: 1791 [revoked], 1867)
  - Code de Commerce 1807: legal capital but no minimum requirements
  - Minimum capital requirements only in 1966
- United Kingdom (concession → general incorporation: 1844)
  - *Gold Mining v Roper* (AC 125 [HL], 1892): No share issues below par
  - Weakened by *Hilder v Dexter* (AC 474 [HL], 1902): No obligation to issue shares above par even where market conditions would allow for it; and by *Re Wragg Ltd* (1 Ch 796 [CA], 1897) re valuation of contributions in kind
    → No minimum capital requirement, virtually free valuation of contributions in kind, no statutory pre-emptive rights; reliance on fiduciary principles.
- Germany (concession → general incorporation: 1870)
  - Introduction of general incorporation was followed by abuse and speculation
  - 1884 reform: Minimum par value RM 1'000, at least five promoters/original shareholders, subsequent adjustments

EU (now Dir. 2017/1132)

- Predecessor: Second Company Law Dir. (1976): Predominantly influenced by DE
- Preamble: Creditor protection and [minority] shareholder protection
- Applies to public companies only
- Legal capital regime (selection):
  - Member states must provide for a minimum capital requirement of EUR 25’000
  - No share issues below par
- Member states implementation:
  - France: EUR 37’000 (listed companies: EUR 225’000)
  - United Kingdom: GBP 50’000
  - Germany: EUR 50’000
  - Switzerland for comparison: CHF 100’000
- See further: 6th lecture (Corporate Finance)

How «thick» is the corporate veil?

- Corporate veil: A separation between the identity of the company (separate legal identity) and the identity of the owners/shareholders
- «Owner» shielding and entity shielding, see above
  → Protection works both ways. But:
  - How strong are the shields?
  - Does it apply to small and large corporations alike?
  - What are the exceptions?
    - Lifting/Piercing the corporate veil, i.e. extending obligations to shareholders (towards creditors of the corporation)
    - «Reverse» lifting/piercing the corporate veil, i.e. extending obligations to the corporation (towards creditors of the shareholders)

Salomon v Salomon & Co Ltd (1897)

- Salomon ran a business of boot making as a sole proprietorship
- He transferred his business to a company (Salomon and Co Ltd) and received shares and secured debt
- The business subsequently failed and went into liquidation
- Salomon intended to recover his secured debt from the remaining value, to the effect that unsecured creditors would have recovered nothing
- The liquidator sued Salomon on behalf of the unsecured creditors, claiming the company was a sham, essentially an agent of Salomon, and, hence, Salomon personally liable to the unsecured creditors

Salomon v Salomon & Co Ltd (1897)

- High Court and the Court of Appeal:
  - The company was a myth and Salmon had incorporated the company contrary to the intent of the Companies Act 1862.
  - The company was an agent of Mr. Salomon and as a result, Mr. Salomon should be liable to pay the debt incurred by the company during the course of its agency.
- House of Lords:
  - As long as a company was duly and properly incorporated, it should be seen as an independent person under the eyes of law.
  - Controlling position and *de facto* control of company's affairs are insufficient
  - Mr. Salomon was not personally liable to pay the debts of the company and also established the "corporate veil" between the company and its owners/shareholders

Salomon v Salomon & Co Ltd (1897)

“The unsecured creditors of Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes.

They trusted the company, I suppose, because they had long dealt with Mr. Salomon, and he had always paid his way; but they had full notice that they were no longer dealing with an individual, and they must be taken to have been cognizant of the memorandum and of the articles of association.”

Lord Macnaghten

Piercing the corporate veil

Jones v Lipman

- Mr. Lipman had agreed to sell a freehold property to the plaintiffs.
- After signing the contract, Mr. Lipman changed his mind:
  - He set up a limited company (in his absolute control), and
  - sold the property to that company: the sole intention to deny the plaintiffs the remedy of specific performance against both Mr. Lipman and the comp.
- The Company was a “mask which [Mr. Lipman] holds before his face in an attempt to avoid recognition by the eye of equity”
- Specific performance against Mr. Lipman and the company

Gilford Motor Company LTD v Horne

- Horne was an ex-employee of the Gilford Motor.
- A clause in his contract of employment with them prevented him from setting up in competition with the company following the termination of his contract.
- Mr. Horne was concerned to avoid contravening his agreement and so incorporated a limited company in his wife's name in order to carry on such a competing business.
- The Court of Appeal: "the company was formed as a device, a stratagem, in order to mask the effective carrying on of business of Mr. Horne"
  - This is a sham
  - No recognition of separate legal personality of the limited company
  - Injunction for Gilford against both Mr. Horne and the defendant company

Daimler Co Ltd v Continental Tyre & Rubber

- Continental Tyre & Rubber was incorporated in England. However, all the shareholders and directors except one were German Nationals.
- In 1914 there was an outbreak of war between the two nations.
- Continental Tyre & Rubber sued Daimler Co Ltd for an unpaid debt.
- The argument of Daimler Co Ltd: Continental Tyre & Rubber is an alien enemy and it is illegal to trade with an enemy. We want to avoid funds going towards the Germans war effort.
- The court had to consider whether they would lift the corporate veil and inquire as to the nationality of the shareholders and consider the ownership of the company.
- As a matter of national emergency, the corporate veil could be lifted, and was. Daimler Co Ltd did not have to pay Continental Tyre & Rubber the debt due.

Corporate Groups

- Group: an aggregation of enterprises that form a business unit, with entities retaining their legal independence.
- Common law countries
  - UK: Statutory rules or court principles
    - Adams v. Cape Industries [1990] = strict application of the Salomon principle
- Civil law countries
  - Germany: “Konzernrecht” = law of groups
- EU law does not regulate veil piercing in context of corp groups
  - Draft EC Ninth Company Law Directive on the conduct of groups was withdrawn

Adams v Cape Industries

- Adams worked for an American subsidiary of Cape Industries (an English firm in the business of marketing asbestos).
- Adams became ill due to his exposure to asbestos dust. When he sought to sue the American subsidiary, he discovered that it had no assets to speak of.
- Adams participated in a U.S. class action against Cape Industries and secured a favourable judgment
- He then sought to enforce the judgment in English courts. In order to do so, he needed to prove that Cape Industries had been present in the U.S. (a prerequisite for being party to an action abroad)
- Court verdict: Adams' arguments (see next slide) were not convincing, and hence the enforcement of the U.S. judgment failed.

Adams v Cape Industries

- Corporate veil cannot be lifted simply on the grounds that the corporate structure has been used to ensure that (future) legal liability would fall on subsidiary rather than Cape Industries
- Acting as a single economic entity in terms of business reality is by itself insufficient to lift the corporate veil
- Subsidiary did not act as a mere agent of Cape Industries

→ Interpretation: Lifting the veil is – also in corporate group matters – limited to bad faith, fraudulence

Group liability

- Law has since been evolving across jurisdictions
- Further causes for parent company/holding liability (by the example of Switzerland):
  - Active involvement – parent company/holding, their representatives are acting as *de facto* organs of subsidiary (BGE 128 III 92)
  - Subsidiary has obviously insufficient assets
  - Parent company/holding and subsidiary cannot be told apart (similar names, same headquarters, same buildings, same representatives, same phone lines etc; Givaudan Decision, BGE 137 III 550), or
  - Trust in the group (Swissair Decision, BGE 120 II 331)

Societas Europaea (SE) – Legal Framework

- Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company
- No comprehensive unified set of rules → European framework that must be filled in by the national law of the respective member states; various legal foundations lead to a coexistence of European and national law
- Hierarchy of legal norms according to art. 9 I SE Regulation
- The Regulation ist directly applicable law in every EU member state, without the need for national implementation

Societas Europaea (SE)

- Nature and structure of the Societas Europea
  - SE is a supranational legal form for companies that operate or wish to operate in various member states of the European Union
  - It offers the possibility to establish companies within the European Union in accordance with largely uniform legal principles
- In many aspects, the SE is comparable to a national public company: Taxation, insolvency rules, and to a large extent also the applicable corporate law are identical to the rules for a national company
- Applicable law: Regulation and Directive / where no provision is made: law of the registered office

Societas Europaea (SE) - Characteristics

- Separate legal entity
- Minimum share capital of € 120’000, divided into shares (mandatory)
- Registered office in an EU member state; relocation to another member state possible
- Basic shareholder rights must be exercised at the Annual General Meeting
- Transferability of assets in accordance with the respective national regulations; a stock exchange listing is not mandatory
- Two possible types of management:
  - Dualistic system (the management board manages the business and is controlled by the supervisory board)
  - Monistic system (an administrative body consisting of at least three directors, including the managing director, assumes responsibility for the management of the company)

Societas Europaea (SE)

- Four different ways to establish a Societas Europea:
  - Merger of existing companies
  - Establishment of a holding company
  - Establishment of a joint subsidiary by several companies or by an already existing Societas Europea
  - Conversion of a national stock corporation
- In principle, only companies from EU and EEA member states can participate in the establishment; another essential requirement is a cross-border element, which depends on the respective form of establishment

Societas Europaea (SE)

- Advantages of the Societas Europea
  - Possibility of detachment from national roots (among others, fiscal reasons)
  - Possibilities for structuring corporate governance (especially in Germany)
  - Autonomy of agreement with regard to the structure of employee participation rights
  - Possibility to choose between a dualistic and a monistic system for the management structure
- Disadvantages of the Societas Europea
  - Lack of uniform statute
  - Complexity due to the various standard layers