THE DUAL STATUS OF THE DIRECTOR-EMPLOYEE

LEE v. LEE'S AIR FARMING LIMITED, [1961] N.Z.L.R.325, J.C.

Salomon v. Salomon & Co. [1897] A.C. 22 is generally cited for the proposition that a company is a legal entity distinct from its members. It certainly emphasised that proposition but if it had said nothing more about corporate personality it would hardly have been worth reporting. The purpose of this article is to demonstrate that the ratio decidendi of Salomon's case is a much more significant principle.

The proposition that a company has a legal personality distinct from its human agencies is of course a fundamental premise of company law. Difficulties arise, however, in its application to one-man companies[1] where the same man performs a variety of functions in various relationships with the company. The danger is not so much that this fundamental proposition will be denied but that it will be rendered nugatory by the application of other rules of law. This danger arises, it is submitted, because nearly all the rules of English law which govern relationships between persons have developed with reference only to natural persons. Normally these rules are still workable when applied to relationships concerning large companies whose corporate existence can be clearly distinguished from that of its human agencies. However, in regard to one-man companies these rules often cannot be literally applied. They may require modification. They may even be quite inapplicable. Regrettably, because of the rigid English doctrine of precedent, the modification of rules of the general law to meet the new situation of the one-man company is seldom frankly acknowledged by the Court.

It will be recalled that, in Salomon's case, the creditors of Salomon & Co.Ltd sought to make Salomon (who owned practically all the shares) personally liable for the debts of the company. Both lower courts[2] held him to be personally liable. Vaughan

1. In the interests of brevity the expression "one-man company" will be used hereafter to denote any company whose shareholding and directorate is dominated by one or two persons.
2. The judgments of Vaughan Williams J. and the Court of Appeal are reported in [1895] 2 Ch.323 sub nom. Broderip v. Salomon.

Williams J. reached this conclusion by holding that the company was Salomon's agent. The Court of Appeal held that the company was trustee for Salomon[3]. It is interesting to note that, although the lower court judgments exhibited some confusion of thought, neither of these views was inconsistent with the proposition that the company had a legal personality distinct from Salomon. Nonetheless, the result of each view was to deny limited liability to a one-man company - the same result as if Salomon and the company were in law one and the same. The House of Lords, of course, reversed the Court of Appeal. Their Lordships refused to apply the rules of agency or trustee law when the result would be, in effect, to abrogate the separate identity of a one-man company, to discriminate between duly incorporated one-man companies and duly incorporated companies generally. Their Lordships declared that, in respect of legal personality, the Companies Acts draw no distinction between companies with few members and companies with many members. So long as the formalities of incorporation are complied with, all companies share equally the full consequences of that incorporation. The broader principle of Salomon's case is therefore a corollary to the principle of separate legal personality: companies, like men, are equal before the law.

Salomon's case was applied by the Judicial Committee of the Privy Council in Lee v. Lee's Air Farming Ltd [1961] N.Z.L.R. 325. In that case the Court of Appeal[4] had applied rules of the general law relating to the master-servant relationship to hold that a one-man company was subject to an incapacity which did not attach to companies generally. The Privy Council reversed the Court of Appeal. In an opinion which re-emphasised the broader principle of Salomon's case, their Lordships quietly modified certain rules of the general law which had produced an unjust result in their application to one-man companies.

Lee's Air Farming Ltd. was a company whose principal object was the conduct of an aerial top-dressing business. It had a

3. Lindley L.J. clearly took this view. Lopes and Kay, L.JJ. seem to have taken this view although neither of their judgments was notable for its clarity on this point.
4. The Court of Appeal's decision is reported in [1959] N.Z.L.R. 393.

nominal capital of £3,000 divided into 3,000 shares of £1 each. Lee held 2,999 shares, the remaining share being held by a solicitor. The Articles of Association appointed Lee to the position of Governing Director for life. While he held that office "the full government and control" of the company was vested in him alone and any minute entered in the minute book of the company signed by him had the effect of a resolution of the company. The Articles also provided that the company should employ Lee as the chief pilot of the company. After the incorporation of the company, Lee was duly appointed chief pilot by an entry in the minute book signed by himself. He worked for the company in that capacity until he was killed in an accident arising out of that employment.

Lee's widow claimed compensation under the Workers' Compensation Act 1922 (now the Workers' Compensation Act 1956).[5] She was entitled to compensation only if Lee was a "worker" within the meaning of the Act. "Worker" was defined in the Act as "any person who has entered into or works under a contract of service ... with an employer ...". Had Lee entered into or worked under a contract of service with Lee's Air Farming Ltd?

The Court of Appeal held that there was no such contract of service. The Court's reasoning may be summarised as follows:

1. In order to determine whether a contract of service existed between Lee and the company the test is whether the company had a "power of control" over Lee.
2. The full government and control of the company was vested in Lee, its governing director. His was the whole "directing mind" of the company.
3. Therefore the company had no "power of control" over Lee, and no contract of service existed between Lee and the company.

North J., who delivered the judgment of the Court, said:

"True, the contract of employment was between himself and the company ... but on him lay the duty both of giving orders and obeying them. In our view, the two offices

5. Although the nominal defendant to Mrs. Lee's action was the company, no doubt an insurance company was defending the action in the name of the company.

> are clearly incompatible. There could exist no power of control and therefore the relationship of master-servant was not created...." ([1959] N.Z.L.R. 393, at 399.)

The Privy Council reversed the Court of Appeal[6] advising that the relationship of master-servant was created and that, accordingly, Lee was a "worker" within the meaning of the Act.[7]

Their Lordships first examined all the circumstances of the case. They pointed out that one of the Articles of Association provided that Lee should be employed as Chief Pilot of the company. This provision was not, by itself, an effective appointment,[8] but one of the first entries in the minute book of the company formally made the appointment. Lee piloted an aeroplane which belonged to the company. He performed top-dressing contracts which were entered into by the company with various farmers. Any profits earned belonged to the company. He was paid wages by the company for this work and the wages were recorded in the company's wages book.

The sum total of all these circumstances made it extremely difficult to avoid the conclusion that Lee was the servant of the company. As their Lordships said (at 333):

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6. According to a note in (1961) 37 N.Z.L.J. 55 this was the first wholly successful appeal to the Privy Council reported since 1946.
7. A number of other decisions which were referred to by the Court of Appeal must now be regarded as bad law. In Brown v. Okiwi Farms Ltd. [1957] N.Z.L.R. 1073, Comp.Ct., Dalglish J. had relied on the question of control to refuse a claim for workers' compensation by a farm worker who was one of two shareholders and two directors of the company who owned the farm. The learned judge applied the principles laid down in four cases before the Workers' Compensation Commission of New South Wales. It is regrettable that, in Lee's case, their Lordships did not take the opportunity of expressly overruling these decisions. Of Brown's case, their Lordships said (at page 337):

> "That case must be regarded as turning upon its own facts."

> "The Court of Appeal thought that his special position as governing director precluded him from being a servant of the company. On this view it is difficult to know what his status and position was when he was performing the arduous and skilful duties of piloting an aeroplane which belonged to the company and when he was carrying out the operation of top-dressing farm lands from the air. ... It cannot be suggested that when engaged in the activities above referred to the deceased was discharging his duties as governing director."

Their Lordships then referred to Salomon's case for the proposition that even a one-man company is an entity distinct from its principal shareholder and director. They concluded that it was a logical consequence of that decision that one person may function in dual capacities. Indeed, there were two decisions, Commissioners of Inland Revenue v. Sansom [1921] 2 K.B. 492, C.A. and Fowler v. Commercial Timber Co.Ltd. [1930] 2 K.B. 1, C.A., where transactions entered into between a one-man company and the one man had been held valid. In brief there was no reason why Lee's Air Farming Ltd., through the agency of Lee in his capacity as governing director, could not enter into a contract with Lee in some other capacity.

The question of control, which had been regarded as vital by the Court of Appeal, received somewhat summary treatment.

Of the New South Wales decisions, their Lordships said (at page 337):

> "As these cases have not been under review and as they so largely depend upon a consideration of their own particular facts and circumstances their Lordships do not include an analysis of them in this judgment."

It is, of course, true that these cases all depend on their own particular facts and circumstances, but the Courts involved in these decisions, like the Court of Appeal in Lee's case, misinterpreted the requirement of control in its application to one-man companies.

8. Eley v. The Positive Government Security Life Assurance Company, Ltd. (1876) 1 Ex.D.88, C.A.

First, their Lordships pointed out that the degree of control exercised over an employee is relevant chiefly "if it is being tested in a particular case whether there is a contract of service as opposed to a contract for services." But in the present case there was nothing to support the contention that Lee was an independent contractor rather than a servant.[9]

Secondly, on the question whether the company had control, their Lordships said (at pp.336-7):

> "There appears to be no greater difficulty in holding that a man acting in one capacity can give orders to himself in another capacity than there is in holding that a man acting in one capacity can make a contract with himself in another capacity. The company and the deceased were separate legal entities. The company had the right to decide what contracts for aerial top-dressing it would enter into. The deceased was the agent of the company in making the necessary decisions. Any profits earned would belong to the company and not to the deceased. If the company entered into a contract with a farmer then it lay within its right and power to direct its chief pilot to perform certain operations. The right to control existed even though it would be for the deceased in his capacity as agent for the company to decide what orders to give. The right to control existed in the company and an application of the principles of Salomon's case (supra) demonstrates that the company was distinct from the deceased."

What the Court of Appeal had demanded was a right of control in the employer which was effective in practice.

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9. It is respectfully submitted that this ground of decision begs the question. It is submitted that the Court of Appeal considered that it was the very lack of control over Lee which supported the contention that Lee was an independent contractor rather than a servant. In the Court of Appeal's judgment, Lee is never expressly called an independent contractor but it is submitted that this must in fact have been the Court's view.

Plainly, Lee's relationship with the company did not satisfy that test. Their Lordships' analysis of Lee's dual capacities revealed only a notional right of control in the company. In holding that the master-servant relationship existed they therefore rejected the Court of Appeal's test - a right of control effective in practice - and substituted a different and less stringent test - a notional right of control which, in the nature of things, could not in practice be exercised. Whereas there was ample authority for the Court of Appeal's test,[10] their Lordships cited no authority for their test.

Was this covert (and decisive) substitution justified? Their Lordships made frequent reference to Salomon's case but the Court of Appeal's decision in no way derogated from the narrow and self-evident principle that a company is a legal entity distinct from its members. It is submitted that their Lordships' substitution of a new test was justified and, indeed, dictated by the broader principle of Salomon's case. None of the authorities which originally postulated the control test for the master-servant relationship had considered the question in relation to the one-man company. The test, designed to investigate relationships between natural persons, fell down in its application to small private companies. It discriminated against the small private company by disabling it from employing its governing director in some different capacity. Such a result was not in accord with the Salomon principle of equality. This principle forced the Privy Council to reappraise the rules relating to the master-servant relationship in their application to one-man companies.

The difficulty which was common to Salomon's case and Lee's case was the necessity to recognise the man who was the principal shareholder and director as acting in more than one capacity.

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10. The control test is the traditional one for determining whether a master-servant relationship exists. The Court of Appeal referred (at page 398) to Humberstone v. Northern Timber Mills (1949) 79 C.L.R. 389, 404 and Attorney-General for New South Wales v. Perpetual Trustee Co.(Ltd) (1951) 85 C.L.R. 237, 300. The test is, however, becoming outdated in favour of an "organisation" test. See Cassidy v. Ministry of Health [1951] 2 K.B. 343, C.A. and Professor Kahn-Freund in (1951) 14 M.L.R. 504. See also Lee v. Lee's Air Farming Ltd, [1959] N.Z.L.R. 393 at 398, line 43.

In Salomon's case the Court of Appeal would not recognise that Salomon could be a secured creditor as well as shareholder and director. In Lee's case the Court of Appeal would not recognise that Lee could be the chief pilot of the company as well as governing director.

And yet, every day, private companies are being formed in respect of which this kind of mental gymnastics is necessary. A typical example would be as follows:

> A, trading on his own account, forms a private company, A & Co.Ltd, with a capital of £1,000 subscribed for by himself (999 shares) and his wife (1 share). A is the governing director of the company for life. He sells his business to the company for £1,750. The price is satisfied as to £1,000 by the shares allotted to him and his nominee. The balance of £750 remains as a debt owing to him by the company.

"A" is concerned in this transaction in no less than five or six capacities:

as vendor of the business;
as promoter of the company;
as a shareholder;
as a creditor;
as governing director;
in some cases (e.g. Lee's case) as an employee of the company.

Each of these capacities gives rise to a wholly different legal relationship with the company. A failure to recognise that A acts in all these various capacities can only result in a restriction of some of the rights, duties, powers and liabilities of the company.

In Salomon's case and Lee's case recognition of these various capacities was refused by the respective Courts of Appeal and was accorded only by the House of Lords and Privy Council respectively. There might have been a third reversal by the highest tribunal if an unfortunate taxpayer had chosen to appeal from the decision of the New Zealand Court of Appeal in Aspro Ltd.

v. Commissioner of Taxes [1930] N.Z.L.R. 935.

The capital of Aspro Ltd was held equally between two shareholders who were also the only directors of the company. Over a period of years, the company paid these men two thirds of the profits, not as dividends, but as directors' fees. The directors' fees were claimed by the company as a deduction for income tax purposes. The majority of the Court of Appeal[11] held that the Commissioner was entitled to call for proof that the "glittering amount" of directors' fees was a proper deduction and that the company had not adduced such proof. Blair J. said (at p.950):

> "Tainted as it thus is with suspicion, it appears to me to be within the Commissioner's rights to call for better evidence of the genuineness of the transaction."

Myers C.J. dissented in terms which anticipated the advice of the Privy Council in Lee's case. He based his judgment squarely on Salomon's case. He said (at p.941):

> "It is the fact, of course, that the two directors happen to be also the two, and the only two, shareholders of the company; but the remuneration is fixed by them not qua directors, but qua shareholders. In other words, it is the company that fixed the remuneration, but not the directors. The question in dispute must, in my opinion, be decided on principle, and I cannot see what difference in principle there can be between a company consisting of only two shareholders and a company consisting of two hundred shareholders. In each case the company is a separate legal entity, and the same principles of law apply to both."

The legislature was sufficiently impressed with Myers C.J.'s dissent to pass an amendment to the legislation expressly authorising the Commissioner to disallow excessive directors' fees as deductions for income tax purposes.[12] The specific decision is accordingly no longer of direct practical importance.

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11. Herdman and Blair, JJ.
12. The provision is now Land and Income Tax Act 1954, s.139.

Nonetheless, the Court's refusal to acknowledge that the same person may act in two or three capacities represents an inroad on the Salomon principle of equality. Decisions of this kind tend to create a special law for private companies. Such a special law, if it checks fraud in one case, is also calculated to stop enterprise in a hundred others.[13]

Accordingly, the advice of the Privy Council in Lee's case will be regarded with pleasure by those who recognise a broader principle in Salomon's case than that which is generally enunciated.

13. See Commissioners of Inland Revenue v. Sansom [1912] 2 K.B. 492, 513, C.A. per Younger L.J.