Piercing the Corporate Veil

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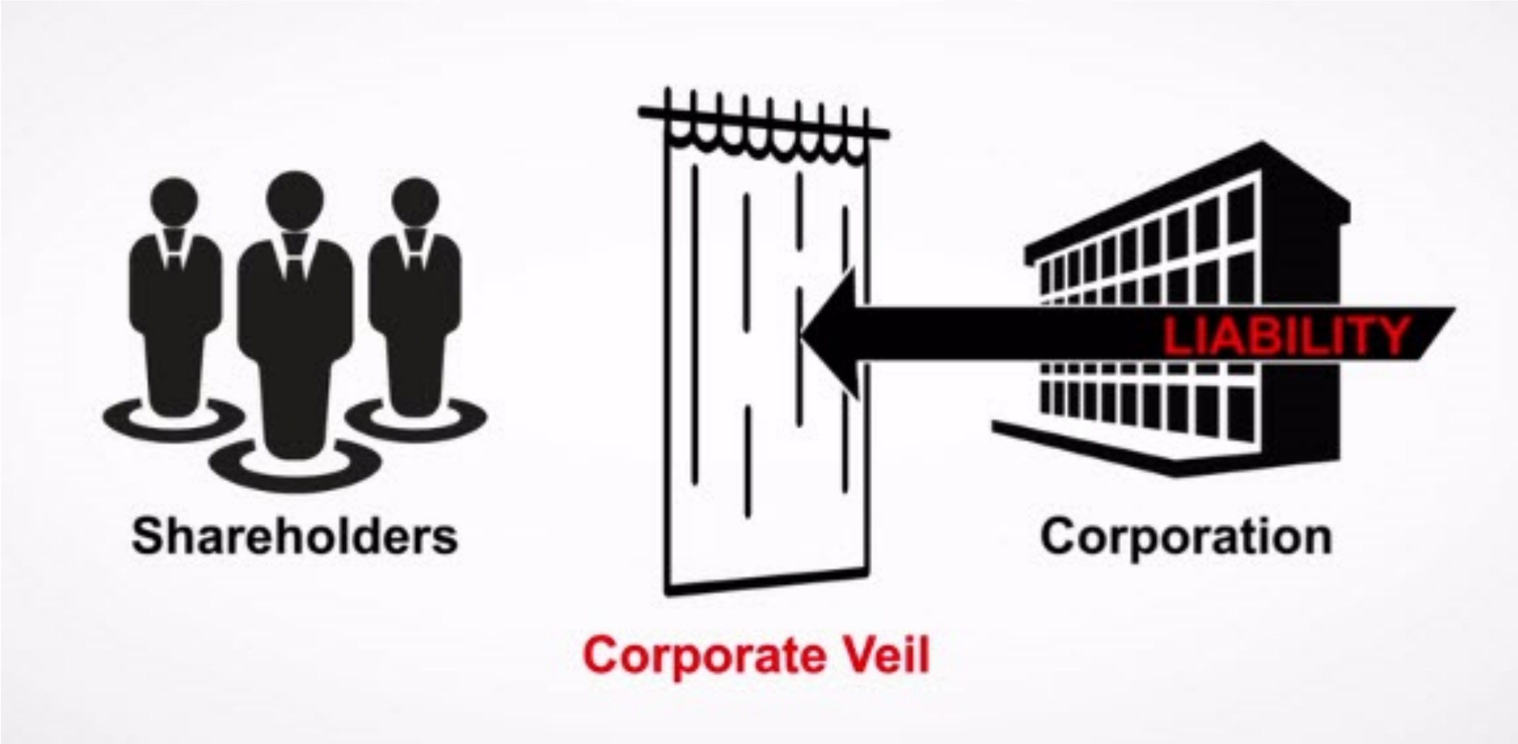
Questions to think for..

- What is a corporate veil?
- What purpose does the corporate veil serve apart from shielding the ownership in a company?
- Are there any *laid down or defined criteria* for disregarding the corporate veil?
- What is the difference between *piercing, tearing and peeping* behind the veil?
- Is it possible to identify an *objective test* for applying the doctrine of corporate veil?

Corporate Veil – Meaning



Piercing of Corporate Veil – Meaning

- Piercing of corporate veil means Judicial Process whereby a court will disregard the usual immunity of corporate officers or entities from liability for corporate activity and impose personal liability on stockholders, officers and directors. (Black's Law Dictionary)
- When corporate personality is being blatantly used as a cloak for fraud or improper conduct the same may be disregarded (Gower)
- There are four inroads which have been made by the law on the principle of the separate legal personality of companies:
  - *the first two are statutory ones related to tax legislations and insolvency provisions*
  - *The third is 'judicial disregard of the principle where the protection of public interests is of paramount importance*
  - *The fourth instance is where the company has been formed to evade obligations imposed by the law.*

Piercing of Corporate Veil – Meaning

- Piercing the corporate veil allows an aggrieved plaintiff the extreme remedy of penetrating the limited liability of a corporation and reaching the assets of its shareholders as the immunity of the corporate shareholders and officers are not absolute;
- Generally three ways are outlined for securing the liability against corporate officers and shareholders:-
  - *Using the common law doctrine of lifting of corporate veil* – generally used by the third party seeking to go behind the corporate existence in order to circumvent the limited liability of the owners and hold them liable for underlying corporate obligations
  - *Showing that the officer or shareholder participated directly in committing a tort;*
  - *By statutory provisions in law;*

Historical Evolution of *Piercing of Corporate Veil*

Its very difficult to say the first case of the application of *disregarding the veil*

Although some commentators have argued in favor of the doctrine, the general perception is that the courts are loathe to apply the doctrine.

Only under exceptional circumstances is veil piercing permitted.

Judicial attitude toward the doctrine, however, has not always been unaccommodating.

Until the late 1970s, English courts demonstrated considerable willingness to pierce the veil when justice so required.

Most notably, Lord Denning propounded the single economic unit theory, which allows a court to treat corporate parent and its wholly owned subsidiaries as a single entity, a theory that would be considered expansive even under U.S. law [*DHN Food Distributors Case (1976)*]

No settled approach in English and Indian courts regarding the application of the doctrine of lifting of corporate veil; US has two pronged approach though but there have been instances of haphazardness

Limited Liability and Doctrine of corporate veil - Relationship

- As per Professor Kennedy in his seminal article on *“Form and Substance in Private Law Adjudication”* ascertains that there is a
  - *Formal and,*
  - *Substantive relation*

  exists between the two concepts which seem to be complimentary and supplementary to each other
- As per *formal terms* limited liability has all the essence of a legal rule whereas the corporate veil doctrine comes as a standard
- As per *substantive terms* limited liability is distinctively individualistic whereas the doctrine possess an altruistic character which helps us to reach the objective of the doctrine i.e. preventing unjust enrichment of the shareholders at the expense of the creditors of the company
- Through general observation, it has been seen that lifting of corporate veil is the anti thesis of limited liability

Major confusions surrounding the *doctrine*

- What purpose does the doctrine actually serve?
- Does it merely reinforce the functions of the law that underlies the corporate veil claim? Or, does it serve any other independent purpose?
- What can be the possible issues such as compensation, deterrence, punishment or something else that tends to get taken care by the application for the doctrine?
- As the metaphor of the veil is of such long standing, it is incorporated in the names of *categories* which reflect the differences of attitude towards the company. These categories, in a progressive order, are:
    - *Peeping behind the Veil*
    - *Penetrating the Veil*
    - *Extending the Veil, and,*
    - *Ignoring the Veil*

Peeping Behind the Veil

- this attitude as an act of curiosity;
  - *the veil is lifted only to get information such as*
  - *involving the persons who control the company, such as who are the shareholders,*
  - *what is the proportion of their holdings, or*
  - *what is their inter-relationship with regard to the control of the company*
- the veil is then pulled down and once more the company is treated as a separate legal personality, to which special characteristics are now attributed in consequence of that 'curiosity
- Lord Denning in *Wallersreiner v Moir (No. I) [1974] 3 All ER 217*

  In my view, however, as long as these cases refer to the place of the official meetings of the company they do not constitute a lifting of the veil: both the meetings of the board of directors and those of the general assembly are functions of the organs of the company. These acts are overt, and no lifting of the veil is required to unveil them. Peeping behind the veil takes place only when the courts or the legislature desire to unveil those who really govern these bodies and give them instruction….. 'It is plain that Dr Wallersteiner used many companies, trusts or other legal entities as if they belonged to him. He was in control of them as much as any "*one-man company*" is under the control of the man who owns all the shares and is the chairman and managing director'

Penetrating the Veil

- more operative with regard to the shareholders;
- the courts reach through the veil and grasp the controlling shareholders personally;
- special mode of penetrating the veil is by way of declaring an agency relationship between the controlling shareholder and 'his' company
  - Case of '*constructive agency*' – agency must be construed on factual findings, where the holding of the shares is only one of the key factors for that decision
  - Agency will precede lifting the veil, it is the other way round. In consequence of ***peeping behind the veil***, the courts reach the conclusion that an **agency relationship exists between the controlling shareholder and 'his' company**. Agency, therefore, is only a way by which the courts **penetrate the veil.** *[Salomon's Case]*
- the purpose of ***penetrating the veil*** is
  - *to impose upon the shareholders responsibility for the company's acts or*
  - *to establish their direct interest in the company's assets.*
- Lord Buckmaster and Lord Wrenbury in *Mucaura v Northern Assurance Co. [1925] AC 619 (HL)*

  'no shareholder has any right to any item of property owned by the company, for he has no legal or equitable interest therein and further on: 'the corporator even if he holds all the shares is not the corporation and neither he nor any creditor of the company has any property rights legal or equitable in the assets of the corporation.

Extending the Veil

- A third technique of lifting the veil is by its extension so that it embraces a bunch of companies – *group companies doctrine*
- the veil of each one of the components is lifted – only to draw it again over a large number of component
- when a group of legal entities is conducting a common activity, so that instead of referring to each one separately, one can regard them all as a single going concern, under one extended veil of incorporation
- Each corporate entity does not concern rather it is '*the enterprise entity*' on which the attention is focused
- The courts have started to follow suit and, in some cases, have taken this approach to a group of companies, without attributing too much importance to the separate entities of its various components

Ignoring the Veil

- The most extreme form of lifting the veil is when the courts ignore it completely.
- This approach is as a sanction *to which the courts turn when they think that the company was not founded for commercial or other sound grounds, but only as a means to defraud or defeat creditors or to circumvent laws.*
- The courts have many names to describe a company which is not a genuine one. ‘Cloak’, ‘instrumentality’, ‘sham’, ‘scheme’, ‘puppet’ or ‘bubble company’ are but a few terms that have been used in this context
- The desire of the court to ignore the company does not always do justice, especially when other parties are affected. In such cases, a remedy can be found in a more conventional way, namely to nullify the hurtful action

Some *major grounds* for *lifting* corporate veil

Judicial Grounds

- Misstatement in Prospectus
- Reduction of No. of members below the statutory minimum
- Failure to refund application fees
- Misperception of the name of the company
- Fraudulent trading
- Investing ownership of the company
- Inducing persons to invest funds in the company
- furnish false statements
- Repeated defaults
- Ultra-Virus Acts
- Internationally avoid legal obligations

Statutory Grounds

Illustration 1

Directors of an Indian company are mostly Singhalese i.e. from Sri Lanka. Recently, India and Sri Lanka have had some hostilities due to which trade ties between the two countries have been severely impacted including the work force and payments to them. Even the Governments of both the countries have imposed severe sanctions on the payment of remuneration to the employees belonging to the other nation.

One of the NGO's have approached the Indian Supreme Court against these actions of the government.

What should be the decision in the above matter using the doctrine of corporate veil?

Answer:

- Case Ref:- Daimler v Continental Tyre Co. [1916] 2 AC 307 (HL)

  Lord Parker:

  "*a company may assume an enemy character . . . if its agents or the persons in de facto control of its affairs . . . are resident in an enemy country . . . The character of individual shareholders cannot of itself affect the character of the company . . . [it] may, however, be very material on the question whether the company's agents, or the persons in de facto control of its affairs, are in fact adhering to, taking instructions from, or acting under the control of enemies. This materiality will vary with the number of shareholders who are enemies and the value of their holdings.*"

Illustration 2

PQR Ltd. claimed compensation for disturbance owing to the expropriation of land. Yet the land belonged to another company MNO Ltd., the shareholders of which were identical to those of PQR Ltd.

Applying the principles of company law justify the claim of PQR Ltd.

Answer:

Case ref:- *DHN Food Distributors Ltd. v London Borough of Tower Hamlets [1976] 3 All ER 852*

Lord Denning agreed with Gower's dictum about the tendency to ignore the separate legal entities of the various companies within a group having regard instead to the economic framework of the group as a whole, said:

> *"this is especially the case when a parent company owns all the shares of the subsidiaries . . . These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says . . . The three companies should, for present purposes, be treated as one... The difficulty of establishing the real relationship between the companies is manifested here: regarding them to be partners, although having said beforehand that they were 'bound hand and foot to the parent company"*

Illustration 3

XYZ Ltd. employs Mr. A as their agent for sales and marketing of their products. Mr. A performs his role efficiently but in the course maintains a record of all his customers with the intention of using it when he'll start his business. Due to certain misunderstandings with the management Mr. A leaves the business and then looks to capitalise on the data base (that he has built while being the employee of XYZ Ltd) by establishing a company MNO Ltd which has similar business like that of XYZ Ltd. When MNO Ltd. starts approaching the customers of XYZ Ltd to use their products instead of *other* companies, Mr. A is served with a legal notice by XYZ Ltd which states that he has violated the non-compete clause.

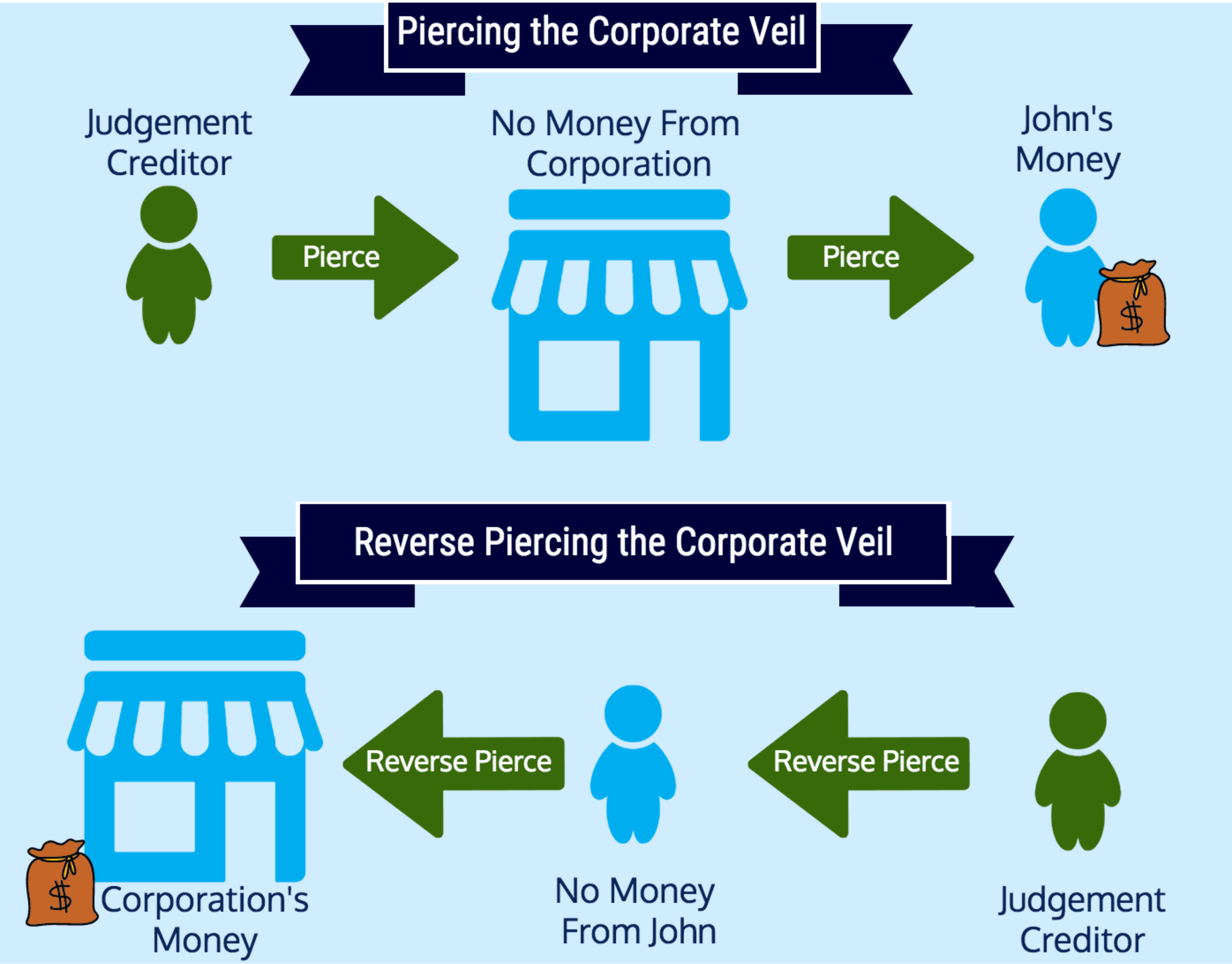
Justify with reasons what should be the liability of Mr. A vis-à-vis MNO Ltd. in the above case.

Answer:

Case ref:- *Gilford Motor Co. Ltd. v Home [I9331 Ch 935, CA.*

Here, a managing director entered into a covenant not to solicit customers from his employers. He formed a company of his own and used it to solicit customers. The Court of Appeal held that *his company was a mere sham to cloak his wrongdoings and an order was issued against him. However the court also issued an injunction against the company, even though the defendant was neither a member nor its director.*

The order against the company is interesting: if the court is to disregard its separate entity, how can it issue an order against it? Indeed, this disregard of the company's entity is unnecessary, as is revealed by the final order of the court. **This extended the veil: it did not make the artificial distinction of who may act in breach of the covenant – the defendant himself or the company**. It contained the injunctions against both, considering them to be one unit – like an enlarged legal entity



Reverse Piercing – Some questions??

- What does 'reverse piercing' mean?
- What are the circumstances where this novel remedy is unfair?
- Is there a principle lurking behind the court's various examples of 'injustice' that falls short of fraud?

Observations about the process of *Lifting* the corporate veil

- One of the most confused area of corporate law as in many cases such as contractual constructions or establishment of jurisdiction the veil has been lifted
- There are various types and methods adopted for piercing the corporate veil.
  - *affirmative asset partitioning (separate patrimony),*
  - *defensive asset partitioning (limited liability),*
  - *forward or reverse lifting/ piercing.*
- According to Easterbrook and Fischel, piercing seems to happen ***freakishly and in an unprincipled manner, and a general consensus amongst the legal fraternity remains that lifting/piercing the veil is one of the most confusing elements of corporate law***

Conclusion

- While English courts are moving towards a principled approach while applying the doctrine of lifting of corporate veil, whereby mere apprehension of deceit or mis-representation shall not suffice, Indian courts are still emphasizing on larger public interest
- Broadly speaking, veil piercing should be abolished or its incidences should be brought down to the bare minimum
- The ***tests*** that shall be truly available can be summarised as follows:-
  - Did the defendant or the shareholder actually commit any wrongful act or offence for which he or she will be directly liable?
  - Did the shareholder commit any fraud which led to the creditor forfeiting contractual protections?
  - Did the shareholders use fraudulent transfers or insider preferences to siphon funds out of the corporation?


THANK YOU