

MISUSE OF CORPORATE VEIL

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INTRODUCTION

Corporate personality has been described as the most pervading of the fundamental principles of company law. It constitutes the bedrock principle upon which company is regarded as an entity distinct from the shareholders constituting it. When a company is incorporated it is treated as a separate legal entity distinct from its promoters, directors, members and employees and hence the concept of the corporate veil, separating those parties from the corporate body, has arisen. The issue of “lifting the corporate veil” has been considered by courts and commentators for many years and there are instances in which the courts neglected from the strict application of this doctrine, this doctrine has been established for business efficacy, necessity and as a matter of convenience.¹

A company is in law regarded as an entity separate from its members. In other words, it has an independent corporate existence. Any of its members can enter into contracts with it in the same manner as any other individual can and he cannot be held liable for the acts of the company even if he holds virtually the entire share capital. The company’s money and property belong the company and not to the shareholders (although the shareholders own the company)

In the year 1897 in *Salomon v. Salomon & Company*, the House of Lords cemented into English law the twin concepts of corporate entity and limited liability. In this case the apex Court laid down the principle that a company is a distinct legal person entirely different from the members of that company. This principle is referred to as the ‘veil of incorporation’. In other words, it has an independent corporate existence. Any of its members can enter into contracts with it in the same manner as any other individual can and he cannot be held liable for the acts of the company even if he holds virtually the entire share capital. The company’s

¹ Lifting of Corporate Veil with reference to Leading Cases, Corporate Law Reporter (2013), http://corporatelawreporter.com/2013/06/12/lifting-of-corporate-veil-with-reference-to-leading-cases/#_ftn2 (last visited Jun 26, 2017).

money and property belong the company and not to the shareholders (although the shareholders own the company).²

The Courts in general consider themselves bound by this principle. The effect of this principle is that there is a fictional veil between the company and its members. That is, the company has a corporate personality which is distinct from its members. The human ingenuity, however, started using this veil of corporate personality blatantly as a cloak for fraud or improper conduct. Thus, it became necessary for the courts to break through or lift the corporate veil or crack the shell of corporate personality and look at the persons behind the company who are the real beneficiaries of the corporate fiction.

The corporate veil is lifted when in defense proceedings, such as for the evasion of tax, an entity relies on its corporate personality as a shield to cover its wrong doings. [BSN (UK) Ltd. v. Janardan Mohandas Rajan Pillai [1996] 86 Com Cases 371 (Bom).]

However, the shareholders cannot ask for the lifting of the veil for their purposes. This was held in *Premlata Bhatia v. Union of India* (2004) 58 CL 217 (Delhi) wherein the premises of a shop were allotted on a license to the individual licensee. She set up a wholly owned private company and transferred the premises to that company without Government consent. She could not remove the illegality by saying that she and her company were virtually the same person.

MEANING

According to the definition of Black Law Dictionary," the piercing the corporate veil is the judicial act of imposing liability on otherwise immune corporate officers, Directors and shareholders for the corporation's wrongful acts."

Aristotle said, when one talks of lifting status of an entity corporate veil, one has in mind of a process whereby the corporate is disregarded and the incorporation conferred by statute is overridden other than the corporate entity an act of the entity. When the principle is involved, it is permissible to show that the individual hiding behind the corporation is liable to discharge the obligations ignoring the concept of corporation as a legal entity. In *DDA v. Skipper*

² Lifting of The Corporate Veil, Law Teacher, <https://www.lawteacher.net/free-law-essays/business-law/article-on-lifting-of-the-law-essays.php> (last visited Jun 24, 2017).

Construction Co. Pvt Ltd, the Supreme Court referred to the principle of lifting corporate veil. The concept of corporate entity was evolved to encourage and promote trade and commerce but not to commit illegalities or to defraud people. The corporate veil indisputably can be pierced when the corporate personality is found to be opposed to justice, convenience and interest of the revenue or workman or against public interest.³

STATUTORY RECOGNITION OF LIFTING OF CORPORATE VEIL

The Companies Act, 2013 itself contains some provisions [Sections 7(7), 251(1) and 339] which lift the corporate veil to reach the real forces of action. Section 7(7) deals with punishment for incorporation of company by furnishing false information; Section 251(1) deals with liability for making fraudulent application for removal of name of company from the register of companies and Section 339 deals with liability for fraudulent conduct of business during the course of winding up.⁴

WHEN WILL COURTS PIERCE THE CORPORATE VEIL?⁵

There are a variety of circumstances when the court will consider piercing the corporate veil. However, while the nuances vary, the underlying theme is the same. When the corporation is being used as a liability shield for the actions of its managers, the courts, if asked, will often be willing to set aside the corporation and hold the managers liable for their acts.

- **Alter Ego:** In an alter ego fact pattern, the corporation is ostensibly serving as a second face for an individual or small group of individuals. This means that rather than doing business in their own names or as a partnership or sole proprietorship, the individual(s) involved have incorporated solely for the benefit of the liability protections of the corporate form.

³ Lifting of Corporate Veil: Indian Scenario, Lifting of Corporate Veil: Indian Scenario, <http://www.legalservicesindia.com/article/article/lifting-of-corporate-veil-indian-scenario-1876-1.html> (last visited Jun 28, 2017).

⁴ Section 7, 251 and 339 of Companies Act, 2013.

⁵ Piercing the Corporate Veil, Piercing the Corporate Veil, https://nationalparalegal.edu/public_documents/courseware_asp_files/businessLaw/Directors&Officers/PiercingCorporateVeil.asp (last visited Jun 30, 2017).

Subsequently, their acts have either turned illegal or abusive, and the courts step in to determine if the corporation or the individuals themselves should be liable.

Typically, an alter-ego-based piercing will occur in a small, closely held company, where the owners of the company have intermingled their personal and corporate assets, and often, their bank accounts. In such a situation, the court may find that the corporation is serving as the “alter ego” for that shareholder, but in essence, is not separate and apart from that owner, and the owner is, therefore, not entitled to liability protection. See *Loving Saviour Church v. United States*, 556 F. Supp. 688 (D.S.D. 1983).

- **Hiding Fraud and Criminal Activity:** Acts of fraud or crimes committed in the name of a corporation but for the benefit of its individual owners constitute a second scenario where courts are likely to disregard the corporate entity. Often, a situation will arise where individual’s intent on a criminal end will incorporate their organization as a way of either masking their own identities or those of their criminal interests. In the end, however, if such a scheme is identified and brought to the court’s attention, it is frequently the case that the court will ignore the corporation and hold its owners and operators liable for the corporation’s crimes. For Example: Guns 'R Us has been selling machine guns, against state and federal law, to individuals with criminal records. The local district attorney chooses to prosecute the company. It quickly becomes apparent that while the bulk of the sales of Guns 'R Us are legitimate, the company’s managers have been engaging in these illegal sales for their own financial profits. As such, the court has little hesitation in piercing the corporate veil and holding both the company and its owners criminally liable.

EXCEPTIONS UNDER WHICH CORPORATE VEIL HAS BEEN LIFTED

1. Wherein the sole purpose for which the company was formed was to evade taxes: In *Juggilal V. Commr. Of Income-tax*, A.I.R. (1969) S.C. 992; In this case the court ignores the corporate entity of a company where it is used for tax evasion. In *Re. Sir Dinshaw Manakjee Petit*, A.I.R. 1927 Bombay 371; the facts of the case are that the assessee was a wealthy man enjoying large dividend and interest income. He

formed four private companies and agreed with each to hold a block of investment as an agent for it. Income received was credited in the accounts of the company but the company handed back the amount to him as a pretended loan. This way he divided his income in four parts in a bid to reduce his tax liability. But it was held “the company was formed by the assessee purely and simply as a means of avoiding super-tax and the company was nothing more than the assessee himself. It did no business, but was created simply as a legal entity to ostensibly receive the dividends and interests and to hand them over to the assessee as pretended loans”. The Court decided to disregard the corporate entity as it was being used for tax evasion.⁶

In *Santanu Ray v. Union of India*, it was held that in case of economic offences a Court is entitled to lift the veil of corporate entity and pay regard to the economic realities behind the legal facade. In this case, it is alleged that the company had violated section 11(a) of the central excises and salt act, 1944. The Court held that the veil of corporate entity could be lifted by adjudicating authorities so as to determine as to which of the directors was concerned with the evasion of the excise duty by reason of fraud, concealment or wilful misstatement or suppression of facts or contravention of the provisions of the act and the rules made there under.

2. Wherein the corporate veil has been used for commission of fraud or improper conduct: The legal personality of a company may also be disregarded in the interest of a justice where the machinery of incorporation has been used for some fraudulent purpose like defrauding creditors or defeating or circumventing law. The two classic cases of the fraud exception are *Gilford motor company ltd v. Horne* and *Jones v. Lipman*. In the first case, Mr. Horne was an ex-employee of The Gilford motor company and his employment contract provided that he could not solicit the customers of the company. In order to defeat this, he incorporated a limited company in his wife's name and solicited the customers of the company. The company brought an action against him. The Court of appeal was of the view that "the company was formed as a device, a stratagem, in order to mask the effective carrying on of business of Mr. Horne" in this case it was clear that the main purpose of incorporating the new company was to

⁶ SECTIONS, ICSI - The Institute of Company Secretaries of India,
<https://www.icsi.edu/Docs/Webmodules/Publications/1.%20Company%20Law-Executive.pdf> (last visited Jun 30, 2017)

perpetrate fraud. Thus, the court of appeal regarded it as a mere sham to cloak his wrongdoings⁷

In the second case of *Jones v. Lipman* a man contracted to sell his land and thereafter changed his mind in order to avoid an order of specific performance he transferred his property to a company. Russell judge specifically referred to the judgments in *Gilford v. Horne* and held that the company here was "a mask which (Mr. Lipman) holds before his face in an attempt to avoid recognition by the eye of equity" he awarded specific performance both against Mr. Lipman and the company. Under no circumstances will the court allow the ant form of abuse of the corporate form and when such abuse occurs the courts will step in and Jennifer Payne in her article lists three aspects of fraud, which needs to be looked at before the corporate veil can be lifted which are, what are the motives of the fraudulent person relevant, Is the character of the legal obligation being evaded relevant, Is the timing of the incorporation of the device company relevant.⁸

3. Wherein it held that the company having an enemy character: A company may assume an enemy character when persons in de facto control of its affairs are residents in an enemy country. In such a case, the Court may examine the character of persons in real control of the company, and declare the company to be an enemy company. For example: In times of war the court is prepared to lift the corporate veil and determine the nature of shareholding.
4. Wherein the company avoid legal obligations: Where the use of an incorporated company is being made to avoid legal obligations, the Court may disregard the legal personality of the company and proceed on the assumption as if no company existed.
5. Wherein the conduct of company conflicts with public policy: The Courts may lift the veil to protect public policy and prevent transactions contrary to public policy. The Courts will rely on this ground when lifting the veil is the most 'just' result, but there are no specific grounds for lifting the veil. Thus, where there is a conflict with public policy, the Courts ignore the form and take into account the substance.⁹

⁷ Ibid

⁸ Ibid

⁹ N. D. Kapoor, *Elements of mercantile law: including company law and industrial law* (1983).

REVERSE PIERCING

There have been cases in which it is to the advantage of the shareholder to have the corporate structure ignored. Courts have been reluctant to agree to this. The often cited case [Macaura v Northern Assurance Co Ltd](#) is an example of that. Mr Macaura was the sole owner of a company he had set up to grow timber. The trees were destroyed by fire but the insurer refused to pay since the policy was with Macaura (not the company) and he was not the owner of the trees. The [House of Lords](#) upheld that refusal based on the separate [legal personality](#) of the company.¹⁰

CORPORATE VEIL FOR HIDING CRIMINAL ACTIVITIES¹¹

Where the defendant used the corporate structure as a device or facade to conceal his criminal activities (evasion of customs and excise duties payable by the company), the Court could lift the corporate veil and treat the assets of the company as the realizable property of the shareholder.

For example, in a case, there was a prima facie case that the defendants controlled the two companies, the companies had been used for the fraudulent evasion of excise duty on a large scale, the defendant regarded the companies as carrying on a family business and that they had benefited from companies' cash in substantial amounts and further no useful purpose would have been served by involving the companies in the criminal proceedings. In all these circumstances, it was therefore appropriate to lift the corporate veil and treat the stock in the companies' warehouses and the companies' motor vehicles as realizable property held by the defendants. The court said that the excise department is not to be criticized for not charging the companies.

The more complex commercial activities become, the more vital it is for prosecuting authorities to be selective in whom and what they charge, so that issues can be presented in as clear and

¹⁰ Piercing the corporate veil, Wikipedia (2017), https://en.wikipedia.org/wiki/Piercing_the_corporate_veil (last visited Jun 23, 2017).

¹¹ Introduction @ Company Law, Legal Bites - Law And Beyond (2017), <https://www.legalbites.in/introduction-company-law/> (last visited Jun 29, 2017).

short form as possible. In the present case, it seemed that no useful purpose would have been served by initiating criminal proceedings. [H. and Others (Restraint Order: Realizable Property), Re, (1996) 2 BCLC 500 at 511, 512 (CA).

CONCLUSION

The act of piercing i.e. the corporate veil until now remains one of the most controversial subjects in corporate law. It is absolutely clear that incorporation does not cut off personal liability at all times and in all circumstances. Those who enjoy the benefits of the machinery of incorporation have to assure a capital structure adequate to the size of the enterprise. They must not do any misconduct with the asset of the company. The Courts have at times seized upon these facts as evidence to justify the imposition of liability upon the shareholders. There are categories such as fraud, agency, sham or facade, unfairness and group enterprises, which are believed to be the most peculiar basis under which the Law of Courts would pierce the corporate veil. The doctrine of lifting the veil has been developed as a device to avoid the hardship of the doctrine of corporate personality. In order to protect themselves from the liabilities of the company its members often take the shelter of the corporate veils. Sometimes these corporate veils are used as a vehicle of fraud, or evasion of tax. To prevent unjust and fraudulent acts, it becomes necessary to lift the veils to look into the realities behind the legal facade and to hold the individual member of the company liable for its acts. The corporate veil has been lifted by the courts and legislatures for the interest of equity, justice and good conscience.