

EVOLUTION OF PIERCING OF CORPORATE VEIL WITH REGARDS TO CORPORATE PERSONALITY

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ABSTRACT

Corporate Veil is a legal concept that separates the identity of a company from its shareholders. It is one of the most unique features of a company over other kind of associations like a partnership. The Shareholders in a company are no liability in the debts a corporation incurs or the credit it is owed. The concept of Corporate Veil has evolved over the years and in cases it has been misused. Personal malice on behalf of certain persons as a part of a corporation has led for the courts internationally to pierce said veil to look at individual roles inside of a company. By this, the courts are technically voiding a company of its basic characteristic feature. This raises the question of arbitrariness in the decision making of the courts. There is thus a clear conflict in the working of the courts and the way a company is designed to work. This paper aims at looking at the interpretation of this concept around the world and analyze the evolution of the piercing of the corporate veil. This paper looks at the conflict between the idea of there being piercing of the veil in regards to corporate personality. For this, the researchers will be looking at various papers written by scholars over the years to understand the need for there to be such a mechanism in place.

The paper would also be looking at various landmark cases to understand the evolution in the usage of the mechanism of piercing the Corporate Veil. This will help come to the conclusion of understanding the jurisprudence behind the usage of this mechanism and the way it has been used over the years.

INTRODUCTION

Corporate Veil is a legal concept that separates the identity of a company from its shareholders. It is one of the most unique features of a company over other kind of associations like a partnership. The Shareholders in a company are no liability in the debts a corporation incurs or the credit it is owed. One of the main motives for forming a corporation or company is the limited liability that it offers to its shareholders. By this doctrine, a shareholder can only lose what he or she has contributed as shares to the corporate entity and nothing more. This concept is in serious conflict with the doctrine of lifting the veil as both these do not co-exist which is discussed by us in the paper in detail.

EVOLUTION OF THE CONCEPT LIFTING OF CORPORATE VEIL

One of the main characteristic features of a company is that the company is a separate legal entity distinct from its members. The most illustrative case in this regard is the case decided by House of Lords- *Salomon v. A Salomon & Co. Ltd.*ⁱ

In this case, Mr. Solomon had the business of shoe and boots manufacture. 'A Salomon & Co. Ltd.' was incorporated by Solomon with seven subscribers-Himself, his wife, a daughter and four sons. All shareholders held shares of UK pound 1 each. The company purchased the business of Salomon for 39000 pounds, the purchase consideration was paid in terms of 10000 pounds debentures conferring charge on the company's assets, 20000 pounds in fully paid 1 pound share each and the balance in cash.

The company in less than one year ran into difficulties and liquidation proceedings commenced. The assets of the company were not even sufficient to discharge the debentures (held entirely by Salomon himself) and nothing was left to the insured creditors. The House of Lords unanimously held that the company had been validly constituted, since the Act only required seven members holding at least one share each and that Salomon is separate from Salomon & Co. Ltd.

The entity of the corporation is entirely separate from that of its shareholders; it bears its own name and has a seal of its own; its assets are distinct and separate from those of its members;

it can sue and be sued exclusively for its purpose; liability of the members are limited to the capital invested by them.ⁱⁱ

Further in *Lee v. Lee's Air Farming Ltd.*ⁱⁱⁱ, it was held that there was a valid contract of service between Lee and the Company, and Lee was therefore a worker within the meaning of the Act. It was a logical consequence of the decision in Salomon's case that one person may function in the dual capacity both as director and employee of the same company.

In *The King v. Portus; ex parte Federated Clerks Union of Australia*^{iv}, where Latham CJ while deciding whether or not employees of a company owned by the Federal Government were not employed by the Federal Government ruled that the company is a distinct person from its shareholders. The shareholders are not liable to creditors for the debts of the company. The shareholders do not own the property of the company.

In course of time, the doctrine that a company has a separate and legal entity of its own has been subjected to certain exceptions by the application of the fiction that the veil of the corporation can be lifted and its face examined in substance.

Thus when "Tata Company" or "German Company" or "Government Company" is referred to, we look behind the smoke-screen of the company and find the individual who can be identified with the company. This phenomenon which is applied by the courts and which is also provided now in many statutes is called "lifting of the corporate veil". As a consequence of the lifting of the corporate veil, the company as a separate legal entity is disregarded and the people behind the act are identified irrespective of the personality of the company. So, this principle is also called "disregarding the corporate entity".

MEANING OF THE DOCTRINE OF LIFTING OF CORPORATE VIEL

Lifting the corporate refers to the possibility of looking behind the company's framework (or behind the company's separate personality) to make the members liable, as an exception to the rule that they are normally shielded by the corporate shell (i.e. they are normally not liable to

outsiders at all either as principles or as agents or in any other guise, and are already normally liable to pay the company what they agreed to pay by way of share purchase price or guarantee, nothing more).^v

When the true legal position of a company and the circumstances under which its entity as a corporate body will be ignored and the corporate veil is lifted, the individual shareholder may be treated as liable for its acts.

The corporate veil may be lifted where the statute itself contemplates lifting the veil or fraud or improper conduct is intended to be prevented.

“It is neither necessary nor desirable to enumerate the classes of cases where lifting the veil is permissible, since that must necessarily depend on the relevant statutory or other provisions, the object sought to be achieved, the impugned conduct, the involvement of the element of public interest, the effect on parties who may be affected, etc.”. This was iterated by the Supreme Court in *Life Insurance Corporation of India v. Escorts Ltd.*^{vi}

The circumstances under which corporate veil may be lifted can be categorized broadly into two following heads:

1. Statutory Provisions
2. Judicial interpretation

STATUTORY PROVISIONS FOR LIFTING THE VEIL

1. **REDUCTION OF NUMBER OF MEMBERS-** Under Section 45 of The Indian Companies Act, 1956, if a company carries on business for more than six months after the number of its members has been reduced to seven in case of a public company and two in case of a private company, every person who knows this fact and is a member during the time that the company so carries on business after the six months, becomes liable jointly and severally with the company for the payment of debts contracted after six months. It is only that member who remains after six months who can be sued.

2. **FRAUDULENT TRADING-** Under Section 542 of The Indian Companies Act, 1956, if any business of a company is carried on with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or fine or both. This applies whether or not the company has been or is in the course of being wound up. This was upheld in *Delhi Development Authority v. Skipper Constructions Co. Ltd.* (1997).
3. **MISDESCRIPTION OF THE COMPANY-** Section 147 (4) of The Indian Companies Act, 1956, provides that if any officer of the company or other person acting on its behalf signs or authorizes to be signed on behalf of the company any bill of exchange, promissory note, endorsement, cheque or order for money or goods in which the companies name is not mentioned in legible letters, he is liable to fine and he is personally liable to the holder of the instrument unless the company has already paid the amount.
4. **PREMATURE TRADING-** Another example of personal liability is mentioned in Section 117 (8) of The English Companies Act. Under this section a public limited company newly incorporated as such must not “do business or exercise any borrowing power” until it has obtained from the registrar of companies a certificate that has complied with the provisions of the act relating to the raising of the prescribed share capital or until it has re-registered as a private company. If it enters into any transaction contrary to this provision not only are the company and its officers in default , liable to pay fines but if the company fails to comply with its obligations in that connection within 21 days of being called upon to do so, the directors of the company are jointly and severally liable to indemnify the other party in respect of any loss or damage suffered by reason of the company’s failure.
5. **FAILURE TO REFUND APPLICATION MONEY-** According to Section 69(5) of The Indian Companies Act, 1956, the directors of a company are jointly and severally liable to repay the application money with interest if the company fails to refund the money within 130 days of the date of issue of prospectus.

6. **HOLDING AND SUBSIDIARY COMPANIES**- In the eyes of law, the holding company and its subsidiaries are separate legal entities.

But in the following two cases the subsidiary may lose its separate entity-

1. Where at the end of its financial year, the company has subsidiaries, it must lay before its members in general meeting not only its own accounts, but also attach therewith annual accounts of each of its subsidiaries along with copy of the board's and auditor's report and a statement of the holding company's interest in the subsidiary.
2. The Court may, on the facts of a case, treat a subsidiary as merely a branch or department of one large undertaking owned by the holding company.

JUDICIAL GROUNDS UNDER WHICH CORPORATE VEIL CAN BE LIFTED

The corporate veil is said to be lifted when the court ignores the company and concerns itself directly with the members or the managers. "It is impossible to ascertain the factors which operate to break down the corporate insulation."^{vii} The matter is largely in the discretion of the courts and will depend upon "the underlying social, economic and moral factors as they operate in and through the corporation."^{viii} It can be said "that adherence to the Solomon principle will not be doggedly followed where this would cause an unjust result"^{ix}. There can be certain circumstances under which the same can take place.

FRAUD: The courts have been more that prepared to pierce the corporate veil when it feels that fraud is or could be perpetrated behind the veil. The courts will not allow the Solomon principal to be used as an engine of fraud. The two classic cases of the fraud exception are *Gilford Motor Company Ltd v. Horne*^x and *Jones v. Lipman*^{xi}. 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 perpetrate fraud.” Thus the court of appeal regarded it as a mere sham to cloak his wrongdoings.

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. Russel J 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 any form of abuse of the corporate form and when such abuse occurs the courts will step in.

In the case of *Hilton v. Plustile Ltd.* the plaintiff and the defendant agreed to use a medium of a company in a tenancy arrangement in order to evade the application of the Rent Act, 1977. The court of Appeal held that the plaintiff was not entitled to lift the veil since he had full knowledge of the matter at all times. However another interesting question that arises is what the effect of deception on the other party is. The issue came up for discussion in the case of *Adams v. Cape Industries Plc.*^{xii} In considering whether the corporate form has been used in such a way as to justify the lifting of the corporate veil, the court stated that the correct test in relation to groups of companies was whether the company had been used as a "mere facade concealing the true facts" applying this test Slade J. said that the "motives of the perpetrator may be highly material" in both the classic cases intention to deceive the plaintiff was very much present however it was not so in *Adams v. Cape Industries.*^{xiii}

TRUST: The courts may pierce the corporate veil to look at the characteristics of the shareholders. In the case of *Abbey and Planning* the court lifted the corporate veil. In this case a school was run like a company but the shares were held by trustees on educational charitable trusts. They pierced the veil in order to look into the terms on which the trustee held the shares.

TORT: Usually the English courts have not lifted the veil on the ground of tort it is a phenomenon not witnessed in most common law jurisdictions apart from Canada.

ENEMY CHARACTER: In times of war the court is prepared to lift the corporate veil and determine the nature of shareholding as it did in the *Daimler case*^{xiv}.

TAX: At times tax legislations warrant the lifting of the corporate veil. The courts are prepared to disregard the separate legal personality of companies in case of tax evasions or liberal schemes of tax avoidance without any necessary legislative authority.

CORPORATE PERSONALITY

Corporate Personality is the creation of law. Legal personality of corporation is recognized both in English and Indian law. A corporation is an artificial person enjoying in law capacity to have rights and duties and holding property. A corporation is distinguished by reference to different kinds of things which the law selects for personification. The individuals forming the corpus of corporation are called its members. The juristic personality of corporations presupposes the existence of three conditions:

- (1) There must be a group or body of human beings associated for a certain purpose.
- (2) There must be organs through which the corporation functions, and
- (3) The corporation is attributed will by legal fiction. A corporation is distinct from its individual members.^{xv}

It has the legal personality of its own and it can sue and can be sued in its own name. It does not come to end with the death of its individual members and therefore, has a perpetual existence. However, unlike natural persons, a corporation can act only through its agents. Law provides procedure for winding up of a corporate body.^{xvi} Besides, corporations the banks, railways, universities, colleges, church, temple, hospitals etc. are also conferred legal personality. Union of India and States are also recognized as legal or juristic persons.^{xvii}

In certain cases, the corpus of the legal person shall be some fund or estate which reserved certain special uses. For instance, a trust – estate or the estate of an insolvent, a charitable fund etc.; are included within the term ‘legal personality’.

CONCLUSION

Thus it is abundantly clear that incorporation does not cut off personal liability at all times and in all circumstances. “Honest enterprise, by means of companies is allowed; but the public are protected against kitting and humbugger”. The sanctity of a separate entity is upheld only in so far as the entity is consonant with the underlying policies which give it life.

Thus 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 withdraw the corporate assets or mingle their own individual accounts with those of the corporation. The Courts have at times seized upon these facts as evidence to justify the imposition of liability upon the shareholders.

The act of piercing the corporate veil until now remains one of the most controversial subjects in corporate law. 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 Courts would pierce the corporate veil. But these categories are just guidelines and by no means far from being exhaustive.

Herein, the whole idea of having a legal entity like a Corporation is to avoid liability on members. The concept of Corporate Veil has arisen in reflection to this characteristic of the Companies. The limitation of liability holds the Company liable for any debt incurred and makes it capable of holding any other person liable as to the credit arisen in name of Company. The Lifting of Corporate Veil is completely against the whole essence of a Company’s establishment but it is necessary to avoid liability upon the association due to the malice of a person or a group inside of the association. This brings specific liability on wrongdoers and avoids it to be put on the other members and shareholders. Therefore, the concept of piercing of Corporate Veil is in place for benefit of the Company though being against the basic essence of Corporate Personality as it tries to limit liability upon the malice creators and not to bring it upon parties not involved. This concept is also there to look into companies made for fraudulent purposes and to help courts investigate upon who is exactly liable inside of an organization (like a Company) in cases where putting liability upon the Company as a whole isn’t the right or just thing to do.

TABLE OF CASES

S. NO.	NAME OF THE CASE	RATIO AND THE IMPORTANT PRINCIPLES LAID DOWN
1.	Salomon v. Salomon [1897] AC 22	House of Lords held that the debts of the corporation were not the debts of Mr. Solomon because they were two separate legal entities; and that once the artificial person has been created, “it must be treated like any other independent person with its rights and liabilities appropriate to itself”.
2.	Daimler Co Ltd v. Continental Tyre & Rubber Co. [1916] 2 A.C. 307 (HL)	In this case, the court held that in times of war the court is prepared to lift the corporate veil and determine the nature of shareholding
3.	Gilford Motor Company Ltd v. Horne [1933] Ch 935 (CA)	In this 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 perpetrate fraud.” Thus the court of appeal regarded it as a mere sham to cloak his wrongdoings.

S. NO.	NAME OF THE CASE	RATIO AND THE IMPORTANT PRINCIPLES LAID DOWN
4.	In Lee v. Lee's Air Farming [1961] AC 12,	The Privy Council held that Lee, as a separate and distinct entity from the company which he controlled, could be an employee of that company so that Lee's wife could claim workers' compensation following her husband's death.
5.	Jones v. Lipman [1962] 1 WLR 832	In this case, 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. Russel J specifically referred to the judgments in <i>Gilford v. Horne</i> 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 any form of abuse of the corporate form and when such abuse occurs the courts will step in.
6.	LIC of India v. Escorts Ltd, AIR 1965 SC 40	In this case, J. Chinnapa Reddy had stressed that the corporate veil should be lifted where the associated companies are inextricably connected as to be in reality, part of one concern. After the Bhopal Gas leak disaster case, the lifting of corporate veil has been escalated.

S. NO.	NAME OF THE CASE	RATIO AND THE IMPORTANT PRINCIPLES LAID DOWN
7.	Adams v Cape Industries plc [1990] Ch 433	The Court of Appeal, in this case rationalized the judicial exceptions to the rule in Salomon and demonstrated that the veil would not be lifted easily even within a corporate group, rejecting claims that the companies were a 'single economic unit' or that the American subsidiary was a facade or that the subsidiary was the agent of the parent.
8.	Tata Engineering Locomotive Co. Ltd. v. State of Bihar And Ors. [AIR 1955 SC 74]	The Supreme Court held that "the corporation in law is equal to natural person and has a legal entity of its own. The entity of corporation is entirely separate from that of its shareholders; it bears its own names and has seal of its own; its assets are separate and distinct from those of its members, the liability of the members of the shareholders is limited to the capital invested by them, similarly, the creditors of the members have no right to the assets of the corporation."
9.	Odyssey (London) Ltd. v. OIC Run Off Ltd. (2000) TLR 201 CA	The court in this case held that it can be said "that adherence to the Solomon principle will not be doggedly followed where this would cause an unjust result"

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 - ^{iv} (1949) 79 CLR 42
 - ^v See Sealy's *Cases and Materials in Company Law*, 9th edn., Len Sealy, Sarah Worthington; Oxford, Pg 53
 - ^{vi} [1986] 59 Comp.Cas. 548
 - ^{vii} Warner Fuller, *The Incorporated Individual: A Study of One-man Company*, (1938) 51 Harv LR 1373, 1377.
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 - ^{xii} *Adams v Cape Industries Plc* [1990] Ch. 433 (CA (Civ Div))
 - ^{xiii} *Ibid*
 - ^{xiv} *Daimler Co Ltd v. Continental Tyre & Rubber Co (Great Britain) Ltd* [1916] 2 A.C. 307 (HL)
 - ^{xv} Section 34 of Companies Act, 1956.
 - ^{xvi} Section 433 to 526 of Companies Act, 1956.
 - ^{xvii} Art 300 of Constitution of India.