

PIERCING THE CORPORATE VEIL

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ABSTRACT

The paper gives a brief introduction to section 9 of the Companies Act 2013, and examines the concept of a company being treated as a separate legal entity. The purpose of this paper, however, is to illustrate the fact that Courts should be restrained from abruptly applying the doctrine of lifting the corporate veil and in turn disregarding the separate legal identity designated by the Companies Act 2013. The paper would further analyse the contentious judgement delivered by the Bombay High Court in *Sir Dinshaw Maneckji Petit v Commissioner of Income Tax* and in turn exhibit the arbitrary nature of Courts when dealing with lifting the corporate veil. The case pertains to the ambit and scope of the concept of a separate legal entity and comprises one of the few instances where the High Court has had the opportunity to lift the corporate veil. Additionally, the paper would provide an in-depth understanding of the arbitrary nature invoked by Courts while piercing the corporate veil and whether the same is disrupting the ease to do business.

INTRODUCTION

The Companies Act 2013, defines a company as an establishment incorporated and registered under the act. ⁱIn common law, a company occupies the position of a legal person or legal entity. It is capable of surviving beyond the lives of its members since it is a distinct legal persona. Under Section 9 of the Companies Act 2013, a company acquires the power to hold and dispose of property, both movable and immovable, under its name. Additionally, it maintains the right to enter into any contract and to sue or be sued. ⁱⁱAs per law, a company is altogether a different person from its subscribers. It may further be possible that even after the incorporation, the business operates precisely as it did before, with the same people managing it and the same hands receiving the profits. However, this does not necessarily mean that the company is their agent or trustee. ⁱⁱⁱThe properties which the company purchases are its own and not that of the shareholders. The company is a corporate body whose existence is unrelated to the motives, schemes, or conduct of individual shareholders. In reality, however, the company's business is regulated by a relatively small group of individuals, who are also beneficial owners of the property. The apex court of the country has placed great emphasis on the fact that the right of a company to be a separate legal entity from its members is subject to the exception of a corporate entity being used as a mere cloak to misdirect the authorities and shareholders.^{iv} The corporate veil is said to be lifted when the court ignores the principle of a separate legal entity and concerns itself directly with the managers or members of the company.

THE FACTS OF THE CASE

The total income of the assessee liable to super tax was Rs. 11,35,102. The Income-tax department accordingly levied a total sum of Rs. 320975 as tax. The assessee's income included two items that formed the subject matter of the dispute. The first one being the interest received on securities amounting to 2,76,800. The second one constituted of dividends received on shares amounting to 1,14,004. The assessee contended that the items formed the income of certain private limited companies that were founded by him and that he merely agreed to hold the shares and securities as a trustee. The dividend collected was portrayed as a loan given by the company to the assessee. Furthermore, he claimed that these companies were the ones liable to super tax and not him. However, The Income-tax Officer believed that these companies had no independent existence and were established merely to avoid tax. ^v

ANALYSIS OF JUDGEMENT

The judgment delivered by the High Court to hold the assessee responsible, was appropriate since individuals should not have the liberty to elude taxes by creating superficial companies. If the courts refrained from examining these companies simply because they are incorporated and have a separate legal existence, instances of tax fraud in the country would surge. The government's major source of revenue composes of taxes, thereby making it imperative for the courts to have the discretion to monitor the activities of such dubious companies. The decision doesn't necessarily conform with the existing law since once a company has been incorporated under the act, it is a separate legal entity. It can enter into multiple contracts, provided that the agreement is lawful^{vi}. The Courts do not have the liberty to analyse every transaction and decide what course of business would be best for the company. Nevertheless, the law has created provisions, for instance, Section 251 ^{vii} and section 7 mentioned under the Companies Act 2013, to empower the courts to take action against individuals who misuse the principle of a separate legal entity.^{viii} The court referred to the judgment delivered in, *The Commissioners of Inland Revenue v John Sansom*, and held that in cases concerning one-man companies, the judgment is entirely dependent upon the material facts presented. ^{ix}For instance, the

aforementioned case was corroborated by the fact that one of the alleged loans had been repaid by the assessee to the family company. But in the present scenario, the assessee did not attempt to present any evidence indicating that he had no bonafide intentions of repaying the loan. The decision delivered by the court will significantly influence existing law and the judgment will be used as a precedent for future disputes where the Court must intervene to make certain that the principle of separate legal entity is not being misused.

WHETHER PIERCING THE CORPORATE VEIL IS ARBITRARY IN NATURE

The courts often justify the piercing of the corporate veil by creating an erroneous impression that they are delivering justice, but this in reality results in the formation of an area in the law, in which the court is unconstrained and is free to impose penalties that fits their view of fairness.

^xThe confusion surrounding the principle of piercing the corporate veil is further compounded by the fact that the judiciary has failed to form a coherent and consistent multi-factored test. For instance, a failure to distribute dividends could be identified as a reason to pierce the corporate veil, however, the payment of dividends in some situation is also considered as sufficient grounds to pierce the corporate veil. ^{xi}Additionally, the judgement delivered in DHN Food distributions Ltd v Tower Hamlets Borough Council, states that the court has the opportunity to lift the corporate veil whenever it is required in the interests of justice to do so or where a corporate group is run as a single economic entity. ^{xii}It is apparent from the aforementioned reasons that the scope and limits of the court to lift the corporate veil remains undefined or uncertain.

In order to provide clarity to the principle of lifting the corporate veil, Lord Sumption introduced the test of evasion and concealment. According to him the concealment does not involve piercing the corporate veil. It is merely lifting the corporate veil in order to identify the “real actors”. While in the case of evasion, there must exist some sort of legal obligation that an individual is attempting to avoid by making use of the company’s separate legal entity. ^{xiii} However, the purpose behind both the methods are the same. Piercing the corporate veil is done

with the intention of depriving the corporation's controller of the added advantage he may get from the company's separate legal entity while lifting of the corporate veil is also done to identify the shareholders in order to attach some liability.^{xiv} The confusion further increases since the courts in particular cases have both ignored the veil and also issued injunctions against the corporation. For instance, in the *Gilford Motor Co Ltd v Horne*, the Court held that the company incorporated by the defendant was a mere sham used to solicit customers and subsequently issued an injunction against it.^{xv} However by issuing an injunction, the court inadvertently treated the company as a separate legal entity after piercing the corporate veil. Thus, advising a one-man company on whether the Court may lift the corporate veil will always remain challenging unless a coherent and practical test for lifting the corporate veil is unveiled.

In order to form a coherent test for lifting the corporate veil, the courts introduced the formation of an agency relationship between the controlling shareholder and his company. The relationship, if proved, claimed that the company did not have any personality of its own and was nothing more than a mere agent for the man. However, this method too was deemed irrational since it permitted courts the right to freely infer the relationship from the ownership of shares alone. The method would have been beneficial if the relationship was constructed on factual findings and not on mere ownership of shares.^{xvi}

It could be argued that the court is able to reach the correct result in a majority of such cases, however the result is merely based on simple intuition and has encouraged the creation of vague assertions and broad generalisation. In the present scenario the piercing of the corporate veil was justified since the purpose behind it was to deprive the controller of the company, the opportunity to evade legal obligation with the help of the corporation's separate legal personality. However, the court failed to provide a clear explanation as to how the assessee was liable for the interest collected on the securities even though the latter furnished a declaration of trust, showing that he was merely holding the property as a trustee. Furthermore, the court formed its argument on the fact that the company was not involved in any active business and termed the same as a mere "holding" company, even though it isn't the duty of the court to inquire what course is best for the business. Instead of attempting to lift the corporate veil, the courts should move their attention to more conventional methods. Even if an individual is under any sort of legal obligation, piercing should only be utilised if there is no other remedy

available^{xvii}. For instance, in cases of property transfer where the sole intention is to defraud creditors, instead of lifting the corporate veil, the courts can issue injunctions against the owner, restraining him from dishing of his property to the company.^{xviii}

WHETHER PIERCING THE CORPORATE VEIL IS DISRUPTING THE EASE TO DO BUSINESS

The primary benefit derived from incorporating a corporation under the Companies Act 2013, is to utilize the significant economic benefits that are associated with limited liability. It provides ordinary citizens with the opportunity to take initiative and embark on new ventures, which would otherwise be hampered with significant threats or uncertainties that are associated with the concept of unlimited liability. It further encourages diversification with regard to equity ownership and ensures that projects which would otherwise have promising returns are not rejected merely because they may be termed as “risky”. Hence, limited liability significantly increases the willingness of individuals to engage in unconventional behaviour.

However, the principle of lifting the corporate veil has had a deteriorating effect on the concept of limited liability. While it is necessary to ensure that corporations and individuals are not indulging in fraudulent activities, the vague standards set by the courts to pierce the corporate veil will only lead to an increase in uncertainty and fear for small business. For instance, if a corporation is unable to fulfil its creditors' demands, such creditors will believe that it is in their best interest to attempt to obtain payment from the owner or shareholders. They will in turn make numerous attempts to persuade the court to lift the corporate veil and disregard its corporate form. The cost of litigation alone will be a substantial amount for these owners and as a result, they will refrain from engaging in economically desirable activities that would otherwise be beneficial for the growth of the country. Moreover, it would be rather bold and unreasonable to assume that everything which may be true in regard to the shareholders activities would be necessarily true in regard to the business conducted by the company.^{xix} For instance, in *New Horizons v UOI*, the plaintiff's bid for a government contract was rejected on the grounds that the company was inexperienced with respect to the work they wished to

undertake. The plaintiff contended that the company's shareholders were well experienced but the Court rejected their argument. The Court believed that if the company was awarded the contract on the basis of the argument raised by the plaintiff then it would be compelled to hold the shareholders liable for a contract entered by the company. ^{xx} Additionally, In *Standard Chartered Bank v Pakistan National Shipping Corp*, the Court held that even though the acts of human agents are attributed to the act of the company, they shall remain the formers own acts. ^{xxi}

In place of lifting the corporate veil, the government should rather enforce stringent liabilities for shareholders who engage in fraud and other wrongdoings. This in turn would ensure that the purpose behind the creation of fear and uncertainty created by statutory provisions, is not to reduce the ease to do business but rather to deter the commission of illegal activities that act as a hazard for the economic growth of the country. ^{xxii}

CONCLUSION

The Companies Act 2013, confers upon a company the privilege of being a separate legal entity. For most individuals, the aforementioned privilege is the sole reason for incorporating their corporation under the act, since it is presumed that they won't be held accountable or personally liable for the actions of the company. Additionally, it provides a sense of security that permits individuals to undertake profitable ventures that would otherwise be dismissed on the grounds of being "high-risk". However, the judiciary is of the opinion that individuals misuse the principle of a separate legal entity to avoid legal liability. For instance, in the case of *Dinshaw*, the principle was used to avoid the tax levelled upon the defendant by the income-tax authorities. ^{xxiii} Nonetheless, it is imperative to be cognizant of the fact that there exists no coherent test to determine in which situations should the corporate veil be lifted. The judiciary, with the help of arbitrary rules and ambiguous precedents, has created an area in law where they are unconstrained and are free to impose penalties that fit their notion of justice. This in turn prompts fear and uncertainty amongst corporations and further affects the ease of doing business.

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ENDNOTES

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- ⁱ Companies Act 2013, s 2 (20).
ⁱⁱ Companies Act 2013, s 9.
ⁱⁱⁱ *Adams v Cape Industries Plc* [1990] CH 433.
^{iv} *State of Karnataka v Selvi J. Jayalalitha* [2017] 201 Comp Cas 230 (SC).
^v *Sir Dinshaw Maneckji Petit v Commissioner of Income Tax* [1927] 29 BOMLR 447.
^{vi} Companies Act 2013, s 9.
^{vii} Companies Act 2013, s 251.
^{viii} Companies Act 2013, s 7.
^{ix} *Commissioners of Inland Revenue v John Sansom* [1921] 9 K.B. 499.
^x Macey J and Mitts J, “Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil”.

^{xi} *Re Paycheck Services 3 Ltd, Revenue and Customs Commissioners v Holland* [2011] 1 B.C.L.C. 141.

^{xii} *DHN Food distributions Ltd v Tower Hamlets Borough Council* [1976] 1 WLR 852.
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^{xiv} Hannigan B, “WEDDED TO ‘SALOMON’: EVASION, CONCEALMENT AND CONFUSION ON PIERCING THE VEIL OF THE ONE-MAN COMPANY” (1990) 53.

^{xv} *Gilford Motor Co Ltd v Horne* [1933] CH 935.

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^{xviii} Ottolenghi s., “From Peeping behind the Corporate Veil, to Ignoring It Completely” (1990) 53.

^{xix} Bakshi P.M., “LIFTING THE CORPORATE VEIL” (1994) 36.

^{xx} *New Horizons v Union of India* [1995] SCC (1) 478.
^{xxi} *Standard Chartered Bank v Pakistan National Shipping Corp* [2000] 1 Lloyd ‘s rep 218.

^{xxii} Smith DG, *Piercing the Corporate Veil in Regulated Industries* (George Mason University School of Law 2008).

^{xxiii} *Sir Dinshaw Maneckji Petit v Commissioner of Income Tax* [1927] 29 BOMLR 447.