

Lifting of the Corporate Veil

ABSTRACT

From the juristic point of view, a company is a legal person distinct from its members [Salomon v. Salomon and Co. Ltd. (1897) A.C 22]. This principle may be referred to as the 'Veil of incorporation'. 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. But, in a number of circumstances, the Court will pierce the corporate veil or will ignore the corporate veil to reach the person behind the veil or to reveal the true form and character of the concerned company. The rationale behind this is probably that the law will not allow the corporate form to be misused or abused. In those circumstances in which the Court feels that the corporate form is being misused it will rip through the corporate veil and expose its true character and nature disregarding the Salomon principal as laid down by the House of Lords. Broadly there are two types of provisions for the lifting of the Corporate Veil- Judicial Provisions and Statutory Provisions. Judicial Provisions include Fraud, Character of Company, Protection of revenue, Single Economic Entity etc. while Statutory Provisions include Reduction in membership, Misdescription of name, Fraudulent conduct of business, Failure to refund application money, etc. This article at first introduces to the readers the concept of "Veil of incorporation", then it explains the meaning of the term-'Lifting Of The Corporate Veil', it then points out the Judicial as well as the Statutory provisions for Lifting of The Corporate Veil with the help of various case-laws.

Introduction-

Incorporation of a company by registration was introduced in 1844 and the doctrine of limited liability of a company followed in 1855. Subsequently in 1897 in Salomon v. Salomon & Company, the House of Lords effected these enactments and cemented into English law the twin concepts of corporate entity and limited liability. In that 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'.

The chief advantage of incorporation from which all others follow is the separate entity of the company. In reality, however, the business of the legal person is always carried on by, and for the benefit of, some individuals. In the ultimate analysis, some human beings are the real beneficiaries of the corporate advantages, "for while, by fiction of law, a corporation is a distinct entity, yet in reality it is an association of persons who

are in fact the beneficial owners of all the corporate property." And what the Salomon case decides is that 'in questions of property and capacity, of acts done and rights acquired or, liabilities assumed thereby...the personalities of the natural persons who are the companies corporators is to be ignored".

This theory of corporate entity is indeed the basic principle on which the whole law of corporations is based. Instances are not few in which the Courts have successfully resisted the temptation to break through the corporate veil.

But the theory cannot be pushed to unnatural limits. "There are situations where the Court will lift the veil of incorporation in order to examine the 'realities' which lay behind. Sometimes this is expressly authorized by statute...and sometimes the Court will lift its own volition".

Meaning Of Lifting Or Piercing Of The Corporate Veil-

The human ingenuity however started using the 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 and look at the persons behind the company who are the real beneficiaries of the corporate fiction.

Lifting of the corporate veil means disregarding the corporate personality and looking behind the real person who are in the control of the company. In other words, where a fraudulent and dishonest use is made of the legal entity, the individuals concerned will not be allowed to take shelter behind the corporate personality. In this regards the court will break through the corporate shell and apply the principle of what is known as "lifting or piercing through the corporate veil." And while by fiction of law a corporation is a distinct entity, yet in reality it is an association of persons who are in fact the beneficial owners of all the corporate property. In United States V. Milwaukee Refrigerator Co., the position was summed up as follows:

"A corporation will be looked upon as a legal entity as a general rule.....but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."

In Littlewoods Mail Order Stores Ltd V. Inland Revenue Commrs, Denning observed as follows:

"The doctrine laid down in Salomon v. Salomon and Salomon Co.Ltd, has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited liability company through which the Courts cannot see. But, that is not true. The Courts can and often do draw aside the veil. They can and often do, pull off the mask. They look to see what really lies behind".

Judicial Provisions Or Grounds For Lifting The Veil-

FRAUD OR IMPROPER CONDUCT- 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 Salomon principal to be used as an engine of fraud. 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 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 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". Therefore he awarded specific performance both against Mr. Lipman and the company.

FOR BENEFIT OF REVENUE- "The Court has the power to disregard corporate entity if it is used for tax evasion or to circumvent tax obligations. A clear illustration is *Dinshaw Maneckjee Petit, Re*;

The assessee was a wealthy man enjoying huge 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 into four parts in a bid to reduce his tax liability.

But it was held that, "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".

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. In *Daimler Co. Ltd V. Continental Tyre And Rubber Co. Ltd*, A company was incorporated in England for the purpose of selling in England,

tyres made in Germany by a German company which held the bulk of shares in the English company. The holders of the remaining shares, except one, and all the directors were Germans, residing in Germany. During the First World War, the English company commenced action for recovery of a trade debt. Held, the company was an alien company and the payment of debt to it would amount to trading with the enemy, and therefore, the company was not allowed to proceed with the action.

WHERE THE COMPANY IS A SHAM- The Courts also lift the veil where a company is a mere cloak or sham (hoax).

COMPANY AVOIDING 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.

SINGLE ECONOMIC ENTITY- Sometimes in the case of group of enterprises the Salomon principal may not be adhered to and the Court may lift the veil in order to look at the economic realities of the group itself. In the case of D.H.N. food products Ltd. V. Tower Hamlets, it has been said that the Courts may disregard Salomon's case whenever it is just and equitable to do so. In the above-mentioned case the Court of appeal thought that the present case was one which was suitable for lifting the corporate veil. Here the three subsidiary companies were treated as a part of the same economic entity or group and were entitled to compensation.

Lord Denning has remarked that 'we know that in many respects a group of companies are treated together for the purpose of accounts, balance sheet, and profit and loss accounts. Gower too in his book says, "There is evidence of a general tendency to ignore the separate legal group". However, whether the Court will pierce the corporate veil depends on the facts of the case. The nature of shareholding and control would be indicators whether the Court would pierce the corporate veil. The Indian Courts have held that a 'single economic unit' argument could work in certain circumstances. These circumstances would depend on the factual control exercised. This view is strengthened by the Supreme Court decision (cited in Novartis v. Adarsh Pharma) in New Horizons v. Union of India. State of UP v. Renusagar was decided in 1988. Back in the year 1988 also, in Renusagar case, the Court proceeded, on the basis of prior English law which had accepted the 'single economic unit' argument. Thus, Renusagar case seems to support the conclusion that a 'single economic entity' argument would succeed in India for lifting the corporate veil.

AGENCY OR TRUST- Where a company is acting as agent for its shareholder, the shareholders will be liable for the acts of the company. It is a question of fact in each case whether the company is acting as an agent for its shareholders. There may be an Express agreement to this effect or an agreement may be implied from the circumstances of each particular case. In the case of F.G. Films Ltd, An American company financed the production of a film in India in the name of a British company.

The president of the American company held 90 per cent of the capital of the British company. The Board of trade of Great Britain refused to register the firm as a British firm. Held, the decision was valid in view of the fact that British company acted merely as he nominee of the American Company.

AVOIDANCE OF WELFARE LEGISLATION- Avoidance of welfare legislation is as common as avoidance of taxation and the approach of the Courts in considering problems arising out of such avoidance is generally the same as avoidance of taxation. It is the duty of the Courts in every case where ingenuity is expended to avoid welfare legislation to get behind the smokescreen and discover the true state of affairs.

PUBLIC INTEREST- 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.

Statutory Provisions For Lifting The Veil-

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.

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).

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 company's 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.

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.

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.

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-

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.

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.

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 humbuggery". 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.