JUDICIAL TRENDS IN LIFTING OF THE CORPORATE VEIL

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ABSTRACT

Over time, it has become customary for certain shareholders to take advantage of the limited liability of corporations in order to defraud the company in order to further their own personal interests. To address this issue, a number of ideas have been established, some of which suggest when judges should ignore shareholders' limited liability, despite the fact that it is recognized by the law. Piercing the corporate veil is the term used to describe these beliefs.

After the much famous Solomon's case, the concept of corporate veil expanded throughout the length and breadth of different legal systems of the world. The Indian legal system, which has adapted much from the colonial masters and their laws, has significantly incorporated this concept and given way to further elucidation of this concept in the courts. The doctrine of corporate veil is inherently a mystical concept, whose application cannot be successfully contained within statutory boundaries. This has resulted in judicially established factors, where the corporate veil is applicable.

The judicially established factors are an inclusive list of some of the fundamental factors, which, according to the courts, mandate piercing through the famed, impenetrable shell of a company and bringing to book those human beneficiaries, who abuse this protection to accrue shady benefits without much accountability. There is a caveat that much of these factors are the results of courts' discretion, which, if not sufficiently guided, may cause unnecessary application of this concept.

CHAPTER I. INTRODUCTION

Since the applicability of the law in a final instance should pass through legal proceedings, piercing the corporate veil is the practice applied and enforced by judges to disregard the rights of shareholders. In this case a limited liability shareholder would be considered unlimited liable for corporate debts, in case the latter have acted unlawfully, to the detriment of society and against any principle of fairness and justice.

The primary and crucial characteristic of a company is its existence as a separate legal entity[1]. The concept of the directors' limited liability, which states that their personal assets won't be utilised to settle any debt, is accompanied by such existence. The freedom to establish company operations that would boost the economy without the directors having to worry about any personal obligation was rather a gift given to the capitalists. The courts quickly understood that while there is fraud going on, the directors cannot be given full protection; simply fining the firm would not be sufficient because the true offenders would not be found guilty. The idea of lowering the corporate veil emerged as an exception to the rule established in the Salomon case, but the debate over whether or not to do so still exists.

The Companies Act 2013 does not explicitly use the term "corporate veil", but offers plentiful provisions on the lifting of the same. For example, under Section 36 of the Act, any member of a company who induces any person to invest in the company shall be personally liable. Under Section 216 of the Act, the Central Government is authorized to appoint inspectors for the purpose of investigating and reporting matters pertaining to the company and its members so as to ascertain persons with real influence or control over the company. Section 448 of the Act punishes any person who furnishes falsified statements such as return, financial statement, etc or conceals any material fact.

The decision to lift corporate veil requires an extensive inquiry into the facts of the present case. There may be circumstances when mere application of statutory provisions does not suffice, and courts have been in those circumstances quite a few times. It has been observed that there is no "unifying principle" for the lifting of corporate veil, and while statutory bodies and authorities may stipulate specific circumstances when the veil can be lifted, there still be

[1] Salomon v Salomon [1897] AC 22

many circumstances beyond what has been stipulated. Hence, judicial developments regarding corporate veil have been plenty.

When one peruses the judicial trends in corporate veil, it is not difficult to realise the relevance of piercing through the corporate shell in corporate governance. With an unfortunate surge in mismanagement and scamming schemes involving tax evasion, etc often operated by individuals under the name of a company, courts have taken it upon themselves to bring to book those who try evading the eyes of law by hiding behind a corporate curtain.

CHAPTER II. CORPORATE VEIL AND THE JUDICIARY

The jurisprudence on corporate veil, in principle, is settled: individuals must not benefit from the shell protection that the distinct corporate personality of a company offers to its members. The application of the concept requires investigation into a number of factors such as control of the respondent, harm caused, and improper purposes.

As early as Solomon, judgments have desired possible exceptions to the separate entity concept. Lord Halsbury recognized the separate entity providing there was “no fraud and no agency and if the company was a real one and not a fiction or myth”. As pointed by Lord Denning **in Littlewoods Mail Order Stores Ltd. v. IRC**[2], “cast a veil over the personality of a limited company through which the courts cannot see. The courts can, and often do, pull off the mask. They look to see what really lies behind”.

The application of these factors may vary and one has to dwell into the facts and circumstances in the present case.

The Indian courts accept the six principles that have been laid down in *Ben Hashem*[3] *case* as follows:

i. ownership and control of a company do not suffice;
ii. the corporate veil cannot be pierced just because interests of justice so require; (iii) there must be a case of impropriety;
iii. the said impropriety must be connected to the exploitation of the nature of the company for the avoidance of any liability;

[2] [1969] 1 WLR 1241
[3] [2008] E.W.H.C. 2380 (Fam.) (U.K.)

iv. to justify piercing the corporate veil, there must be presence of control and impropriety, so as to employ the company as an instrument to provide a protective cover to such act impropriety[4]; and

v. Irrespective of the original intention of the incorporation of the company, the company has been used as a 'facade' to further an illegitimate transaction in a present case.

Even prior to the *Ben Hashem* principles, the courts adhered to similar jurisprudence in determining the circumstances when veil can be lifted. The following discussion contains enumeration of many judicial trends in the development of the concept of corporate veil that show how the jurisprudence on corporate veil took shape:

a) Tax Evasion and Non Paymentof Revenues

There have been plentiful cases in which a Company was incorporated with the sole objective to utilize it as an instrument to forestall payment of revenues, or to evade taxes or to obstruct observance of its obligation. Perhaps, the most infamous use of corporate personality is in tax evasion and deviation of revenues for personal motives.

The case of **Dinshaw**[5], in which the assessee was an affluent man who enjoyed handsome dividends as well as interest income, is a good case to start with. He had created four private companies and agreed with each to hold a block of investment as its agent. He put to use these companies to hold his income on his behalf and then hand it over to him in the form of an ostentatious loan The court made an observation stating that the companies were not engaged in any business and their sole purpose was to hold dividends on behalf of the assesse until they were handed over to him in the form of ostentatious loans.

In English courts the most relevant and recent doctrine of veil piercing in the UK was developed in 2013 as a result of the case **Prest. V Petrodel Resources Ltd**[6] where the famous Judge Lord Sumption made an interesting distinction between two principles, namely concealment and evasion. There is "concealment when a subject interposes a company in an attempt to conceal his real identity, whereas evasion occurs when there is a legal right against a subject and the company is interposed in order to defeat this right or frustrate its enforcement". According to Lord Sumption's provision, only in this latter case the court may

[4] Ibid.
[5] Dinshaw Maneckjee Petit, Re, A.I.R. 1927 Bom 371 (India).
[6] [2013] UKSC 34, [2013] 2 AC 415

hypothesize piercing the corporate veil[7]. Briefly quoting Sumption, “for the principle of shareholders’ limited liability there is a limited exception that is based on public policy. The exception applies where a person is under legal obligation or liability or subject to some legal restriction and he deliberately evades it or frustrates its enforcement by interposing a company under his control. In such a case, if there is no other way of giving effect to the liability for obligation or restriction in question, the court might disregard the separate legal personality of the company”.

Furthermore, the said exception to limited liability, can be implemented “only for the purpose of depriving the company or its controller of the advantage they would otherwise have obtained by interposing the company”[8].

b) Fraudulent and Improper Conduct

The courts will not uphold the company's independent existence if it was established to violate the law, cheat creditors, or escape legal duties. It may be noted that “a company cannot be prosecuted for cheating and conspiracy because such offences require mens rea”.[9]

In **PNB Finance Ltd. V Shital Prasad Jain**[10], the defendant took loan from the plaintiff company for the purpose of purchasing immovable property. The defendant was required to deposit the property's title deeds with the plaintiff corporation as collateral before the loan could be approved. The defendant did not make any payments toward the principle and interest, but instead moved the money to three public limited companies that he and his son had established. The money from these companies was then used to buy real estate. The plaintiff firm filed a lawsuit, alleging that the defendant had committed fraud by not buying the property in his own name and instead transferring it to the three companies, which intended to be formed for the plaintiff's benefit. The court permitted the plaintiff company to attach the assets of such companies as they were held to be created only to hoodwink the plaintiff company.

The tragic **Satyam scam** serves as a sombre reminder that businesses can be exploited as instruments for successfully concealing important information and cheating individuals for private gain. By exaggerating profits in the company's financial statements, Ramalinga Raju and his confidants in high positions defrauded a company of its funds and business

[7] Prest v Petrodel
[8] Ibid.
[9] A.K Khosla v. T.S. Venketasan (1994) Cal.
[10] (1983) 54 Comp. Cas. 66 Del.

opportunities by inflating profits in the company's financial statements. As a consequence, the health of Raju' s companies was understood to be positive and many investors invested in the company, thinking that they would get high returns which, of course, they did not. Just like *Satyam* (though not as humungous as this), there have been many other cases where members of a company tried defrauding people associated with it in which the court unflinchingly lifted the corporate veil and brought to book those with malicious intents.

The English jurisprudence, on this point, is quite agreeably followed in India courts. For example, the observations in the **case of Horne**[11] are popularly referred to. In this case, the court ruled that the company, in the present case, was created to serve as a "stratagem" to put a concealer on the underhand business activities in which EB Home was involved and this did not go down well with the Court. An injunction was granted against both him and the company to restrain them from carrying on the business. The company was described inthis judgement as “advice, a stratagem”, and as “a mere cloak or sham for the purpose of enabling the defendant to commit a breach of his covenant against solicitation”.

In **Subhara Mukherjee v Bharat Coking**[12], the parliament vested with itself the right, title and interest of the owners in relation to the coal mines specified in the Schedule appended to the Act vested in the Central Government. The plaintiff appealed, claiming that the suit property that the appellants had vested in their favour was a fake, the result of collusion, was given without consideration, and was created in order to escape the effect of the suit property's vested status under the Act of 1973.

In the sensational **case of Sahara**[13], the Securities Appellate Tribunal considered the question whether the corporate veil should be lifted. The Sahara group had argued against any such move to lift the veil, as it is separate legal entity different from its members and therefore, SEBI should not be allowed to exercise its power to lift corporate veil under the SEBI Act 1992. The Tribunal noted that the SEBI Act authorizes the SEBI to lift the corporate veil of a regulated entity so as to preserve and protect the interests of shareholders. It was found that there is an individual director/promoter who, on the face of it, is found to be in complete managerial control of and exercising substantial influence over the companies in question.

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[11] Gilford Motor Co. v Horne , [1933] Ch. 935 (U.K.).
[12] (2000) 3 SCC 312
[13] Sahara Assets management Co. Pvt. Ltd. V. Securities and Exchange Board of India, Appeal No. 428 of 2015 (India).

Such circumstances, therefore, makes it necessary that the SEBI lifts the veil to uncover the truth underlying the substance of the companies.

c) Ascertainment of the Character of the Company

A corporation's nature and constitution are viewed as highly determinative aspects to identify who the real individuals are behind its acts, making it imperative to ascertain how the members of the company stand in relation to the firm itself. As a result, it is important to find out who runs the business, where all of the members are from, their nationalities, where the company was founded, etc. The reason for this is that the presence of hostile members may indicate the existence of an unfavorable agenda that needs to be stopped in its tracks.

In *Daimler*[14], a case which is often relied upon in the Indian courts, the House of Lords decided to lift the corporate veil and held that a company cannot, itself, acquire an enemy status, but such character can be reflected on its operations through its members.

Taking into account the Daimler case, the Supreme Court in State Trading Corporation of India[15] noted that the question of ascertaining the enemy character of a company becomes material during wartime. It stated that the law of nationality becomes heavily operable during wartime to determine whether a particular entity is enemy in nature, and hence, companies of other nationalities cannot claim benefits which they, otherwise, enjoyed during peacetime.

Thus in the above case, the court disallowd the action in the public interest. But where there is no such danger to public interest. But "where there is no such danger to public interest, the courts may refuse to tear open the corporate veil".[16]

d) Agency of Trust

When a company acts on behalf of its shareholders, the shareholders are responsible for the company's actions. In each situation, it is a question of fact as to whether the corporation is representing its shareholders. There may be an assumed agreement or there may be an express agreement to this effect. A corporation may occasionally be viewed as an agent or trustee of its members or of another company, even though a parent and a subsidiary, even a 100% subsidiary, are separate legal entities and even a government firm is not a department or an extension of the State. The relationship of agency must first be firmly established for that,

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[14] Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd, [1916] 2 A.C. 307 (U.K.).
[15] State Trading Corporation of India Ltd. V. Commerical Tax Offcier & Ors, 1964 S.C.R. (4) 89 (India).
[16] People's Pleasure Park Co. v Rohleder (1908) 109 Va 439,

though. Whether the subsidiary company is running the parent company's business on its own is a factual issue in each case.

In **Kapila Hingorani v State of Bihar**[17] it was held that lifting of the veil of government companies is permissible when the corporate personality is found to be opposed to justice, convenience and interest of the revenue or workman or against public policy. Thus, in this case, the government was not allowed to shelter behind the lack of resources in discharging its obligations to pay wages of the employees of a Government company.

The Court noted that while the state may not be liable for the PSUs' regular operations, it would become liable if it failed to carry out both its constitutional obligations and these enterprises' roles. Because "life signifies something the functions of these endeavours," this is the case. It is so because, "life means something more than mere ordinal existence. The inhibition against deprivation of life extends to all those limits and faculties by which life is enjoyed".

Under no circumstances are the judicial trends stated above comprehensive. The "corporate veil" body of law has developed throughout time in response to business demands. The Indian courts did not have to start from scratch because there was a wealth of English and American legal precedent on this topic. However, Indian courts were able to influence the jurisprudence through the use of their own imaginative interpretation, and as a result, we now have significant case law that has given the corporate veil notion more structure and substance.

CHAPTER III. CONCLUSION

Ensuring a principle of limited liability is beneficial for a country's social and economic development but at same time, limited liability might contrast with any sense and principle of fairness and justice. This is why Judges started elaborating theories of piercing the corporate veil by relying on other principles and provisions.

As a result, when developing theories on veil piercing, researchers should take into account the fact that the veil piercing issue is characterized by two opposing interests. Respecting the principle of limited liability on the one hand ensures economic and social growth, while enabling the veil of limited liability to be lifted on the other ensures justice. The question that now arises is: Which of these two interests is better for society as a whole? In fact, some

[17] (2003) 6 SCC 1

academics supported limited liability, while others emphasised the importance of justice as the cornerstone of a system of the rule of law and, by extension, of a democratic system.

Ordinarily, the liability of shareholders is limited to the amount paid for shares in a company. The general principle of limited shareholder liability is a fundamental principle in the corporate law. A company is deemed to be separate from its members, and hence, has its own set of liabilities that cannot be imposed on its members. The underlying objectives of this principle are to further economic interests of the companies and prevent imposing extraneous burden on their members; however, there are and will always be miscreants who would try exploiting all avenues to abuse this protection.

In this regard, the author holds the view that economic and social progress cannot be made at the expense of justice for corporate creditors. In fact, if judges do not ensure that creditors are treated fairly, not only would the fundamental idea of the rule of law, which is characteristic of contemporary democracies, be jeopardised, but even market participants would be dissuaded from making contributions to the smooth operation of the market as a whole. Accordingly, it is affirmed that when shareholders deceive or merely mislead corporate creditors by supplying incorrect or misleading information, that is, when they make false statements, the market's ability to function should be seen to be damaged. In fact, the availability of such information is necessary for creditors to assess the risks associated with their investments, which is a crucial prerequisite for the market to operate efficiently.

In conclusion therefore, it may be maintained that to some extent, Prest has stabilized the tendency of the court’s attitude toward piercing the corporate veil to shift from time to time by providing some degree of clarity, but this is not without flaw. Prest relegated veil-piercing to instances of evasion only, and in so doing, has triggered a dominant trend in company law to return to a strict Salomon principle and so limit the instances wherein which a company’s separate legal personality can be disregarded to impose corporate liability.