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Piercing the Corporate Veil: A Necessary Puncture in the Fabric of the Corporate

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The central theme of this paper is the concept of the lifting of the corporate veil as an exception to the limited liability of members of a company. The paper encapsulates all elements required for an in-depth understanding of the concept. An elementary understanding of the company, followed by a sequence of charting the historical course of a corporate from the introduction to the paper. The core concept is introduced in the context of The Companies Act, of 2013.[1] *The origins, definition, and analysis of the Corporate Veil Theory are discussed. Further, the need for a piercing corporate veil has been examined. Statutory references have been inculcated for better reasoning and understanding. The circumstances in which the Corporate Veil is pierced have been scrutinized with the help of respective case laws. The content has been summarized with a brief precis and the author's personal views on the matter.*

Keywords: *corporate veil, piercing of corporate veil, company, director.*

[1] Companies Act 2013

INTRODUCTION

6000 years and counting of civilization and we've evolved in facets other than genetic; livelihood, standard of living, regional and societal institutions, and structure, culture, sustainment- you name it. What started as fending for oneself or self-sufficiency to making ends meet for one's tribe to raising surplus stocks and profiting from them to a medieval form of trade to modern business- the essence at heart remains the same, 'survival, in the most sheltered way possible. In today's day and age, with better connectivity, interoperability, rising demand, better technological instruments, and respective legislative mechanisms, the corporation is the most popular form of business organization[2].

HISTORICAL BACKGROUND

The modern, developed corporate is a product of the much simpler trade organizations that came before it. A quick look at the development of business enterprises dating back to 800 B.C. presents us with precursors to the corporate form in India. In addition to family-run enterprises and privately owned companies, several ways to do business or engage in group activity existed in ancient India, including the gana, pani, puja, vrata, samgha, nigama, and serene. All of these were forms of syndicates; serving different purposes but formed on the same philosophy. The game and samgha appear to be more broad terms for political and religious bodies. The page and vrata refer to groups whose members frequently had economic goals but were also citizens of a town or community that was entirely dedicated to a certain vocation. The terms "enigma" and "serene" are most frequently used to describe commercial, artistic, and maybe paramilitary groups. Lastly, the "pain" is frequently seen as a representation of a caravan of merchants journeying to transact. From our records, we see a primitive form of a corporate- constitution, administration, functioning, liabilities, etc. arise. For the sake of longer-distance travel and commerce over land and the sea, there is evidence that traders frequently organized into partnerships. These are often engaged by two or more persons, and they choose a leader. The

[2] Robert C Clark, *Corporate Law* (Little Brown 1986) 1

partnership's actions would be governed by the entity, which also looked to have the capacity to possess assets independently of the partners.[3]

These two characteristics provide the entities with the legitimacy of a contracting entity[4]. Additionally, throughout the years, rather intricate procedures for the separation of assets and obligations evolved. In the absence of an agreement, the laws in effect at the time that divided assets and liabilities equally or, occasionally, the proportionate contributions (talent, labour, and capital) made by members of the company might be used to determine how assets and liabilities should be shared.[5] The latter was more typical in joint ventures amongst artisans. Additionally, it appears that there were requirements that were comparable to the duties of loyalty and care that are so prevalent in modern fiduciary obligations. The partners sat in judgement on their co-partner and determined whether such neglect occurred for a cause of action based on a partner's negligence harming the partnership. If the partner was determined to be culpable, he was responsible for covering the damages. The responsibility of care we have now has some similarities to this. Additionally, the accused partner would be put through some sort of test or oath if the accusation was one of fraud. If the partner failed, he would be required to make up the partnership's losses, lose his gains, and be ousted from the business.

North-west of the Indian Peninsula, Rome, along with its remarkable achievements in infrastructure, urbanization, and commercial facilities, is renowned for its military and political-administrative growth. Famous Roman roads and aqueducts, temple construction, and military expedition funding enforced a strict corporate structure that was particularly capital-expensive. Society, which refers to an agreement amongst Roman citizens to share the profits or losses of a company, was the most basic type of economic organization in ancient Rome. This term is sometimes translated as "partnership." Due to the absence of the reciprocity component, these societies had nothing in common with modern forms of partnership. The rule, which now is

[3] *Ibid*
[4] PN Agrawala, *A Comprehensive Business History of India* (Tata McGraw-Hill Publishing Company 2004) 259
[5] *Ibid*

known as the "default of shared responsibility in the face of a debt", was more of a "pro-rata" obligation to the Romans[6].

CONCEPT OF CORPORATE VEIL

This, with shifts in the geo-political, socio-economic and technological atmosphere has concocted the modern corporation, which, as under the *Companies Act, 2013*[7], is defined as a company incorporated under this Act or any previous company law'. A company is understood to be a legal entity formed by a group of individuals to engage in and operate a business, commercial or industrial enterprise.

It is this endowment, this bestowing of 'legal entity status on the company that forms the essence of this paper.

A company is an artificial legal person, meaning

- It is created by law, not using natural birth;
- Can do everything except being imprisoned, take an oath, marry or practice the profession;
- Acts through a human agent.

Once incorporated, the company becomes a distinct legal entity in the legal sense. The company has the same legal rights as an individual, including the ability to operate under its name, have its seal, enter into contracts, buy or sell property, open a bank account, and bring or defend legal actions. Ultimately, a corporation is a legal person distinct from the individuals who constitute it.

A director is defined as "a director appointed to the Board of a company" under the Companies Act of 2013 (or "CA 13"). In CA 13, the idea of an "officer who is in default" is used to attach culpability to that individual for any violations of CA 13's rules committed by the corporation.

[6] Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of The Civilian Tradition* (Clarendon Press 1996) 455
[7] Companies Act 2013

Every full-time director is included in the expansive definition of "officer who is in default." A company is a legal entity, but because it must act via a real person, the board of directors (the "Board") of a company makes decisions on its behalf. Unless the Board of the company specifically grants him/her a particular power, or unless the company's bylaws expressly grant such a power, no individual director has the authority to act on behalf of a company of which he/she is a director. Directors' responsibilities are essentially derived from the law of agency and trusts under common law standards and equitable principles. Directors are required to use skill, care, and diligence under the law of agency. However, directors are required to fulfill fiduciary responsibilities under trust law. As a result, directors function as trustees for the funds and assets of the company and as agents in any agreements they engage in on the company's behalf. Director is required to do their tasks with the knowledge, competence, and experience of both the person performing their role and of the director. Directors engage in contracts as the firm's representatives (to the degree permitted by the corporation).

By holding the position of director, a person is often not responsible for the company's obligations. In this sense, the law is well established and has been reaffirmed by courts in several rulings. For instance, the Delhi High Court affirmed the deletion of the director's name from the complaint filed, inter alia, for recovery of the unpaid sum and damages, and made the following remarks in the matter of "*Tristar Consultants v M/s. V Customer Services India Pvt. Ltd. & Another*"[8]:

"*Directors of companies have been described as agents, trustees or representatives of the company because of the fact vis-a-vis the company they act in a fiduciary capacity. They perform acts and duties for the benefit of the company. Thus, directors are agents of the company to the extent they have been authorized to perform certain acts on behalf of the company.*

But directors of a company owe no fiduciary or contractual duties or any duty of care to third parties who deal with the company...

[8] *Tristar Consultants v M/s V Customer Services India Pvt Ltd & Anr* AIR 2007 Delhi 157

To interpret the law as is sought to be projected by the petitioner would mean negation of the concept of a company being limited by its liability as per the memorandum and articles of association of the company."

In other words, unless fraud or egregious negligence on the part of the director(s) is/are proven against him/them in the course of conducting the business of the company at the relevant time, the director(s) is/are not held personally accountable on behalf of the company. This shielding of the directors from responsibility for missteps of the company and its consequences is known as putting up a 'Corporate Veil'.

LIFTING OF CORPORATE VEIL

The foundation stone of Corporate Veil was the famous case *Salomon v A. Salomon & Co. Ltd.*[9]

Facts: In the aforementioned instance, Mr. Aaron Salomon was a successful bootmaker operating as a lone proprietor. He decided to form A. Salomon & Co Ltd in 1892, which was officially incorporated under the Companies Act of 1862. Along with his wife and their five children, he appointed his two sons as the company's directors, and they all became stockholders. After the firm was founded and incorporated, he sold his boot manufacturing company to the same company and received 20,000 £1 shares and £10,000 in debentures in exchange for the $39,000 worth of boot manufacturing business. As security for the debentures, he also obtained floating charges over the company's stock in trade.[10]

Issue: Mr. Bordip was incensed by this circumstance, and the business's liquidator argued that Mr. Solomon should be held accountable for the debts of the company just as he would have been if he had been a sole proprietor. Mr. Bordip defended his position by claiming that the formation's primary goal was to mislead the creditors, and as such, the amount paid to acquire the boot manufacturing company was exorbitant. In the first instance, Mr. Bordip brought a lawsuit, but Vaughan Williams J. rejected his assertions. Instead, it was discovered that the corporation was acting as Mr. Solomon's agent and acting as his principal. Mr. Solomon was

[9] *Salomon v A Salomon & Co Ltd* [1896] UKHL 1
[10] *Ibid*

requested to protect the company's creditors from the company's creditors when it was determined that the company's members were dummies.

Ruling: The Court of Appeal upheld the High Court's ruling in this judgement written by Lindley LJ, who also acknowledged that the company had complied with all applicable laws. However, the judge went on to say that the company was formed for "illegitimate purposes" and as a "device to defraud creditors," and since creditors could not reach Solomon directly as a result of the company's formation, he is now liable to indemnify the company. Similar to Lopes' ruling, Kay L.J.'s ruling ruled that the business sale to the company was invalid and once more assigned Mr. Salomon the duty of compensating the firm for the transaction's costs, debenture interest, and acquired obligations. The house of lords ultimately rejected all earlier rulings that included a fraudulent ad agency and upheld Mr. Salmon's appeal. The lords ruled in this judgement that the corporation had been purchased into a legitimate existence with strict conformity to the laws and regulations outlined in the acts. Keeping in mind that the business and Mr. Solomon are independent legal entities and are not responsible for any damages. This case law affirmed two additional crucial novel ideas: first, it openly acknowledged that the concept of a "one-man company" existed before the government officially authorized it in 1992; second, it ruled that a relationship of agency or trust cannot be inferred from ownership of shares. The idea of a separate legal entity that was thus founded has had broad ramifications and has established an unwavering precedent all across the world. This idea was well-liked because it allowed people to benefit from economic possibilities without being personally exposed to extra risks and obligations by providing the firm and shareholders with a separate life.

This concept enables members of a company the benefit of not being liable for the company's obligations, save to the extent that they are held liable by law or by the company's charter, and they also do not have any proprietary interest in the company's assets.

However, humans are the true and final beneficiaries of corporate benefits. In practice, a company is a group of people who are the actual beneficiaries of the corporate property, notwithstanding the legal illusion that it is a separate entity. However, there are situations in

which it is necessary to lift or pierce the veil of a separate legal entity, such as when fraud, improper conduct, tax evasion methods, statutory violations or obligations, tortious liabilities, agreement breaches, or the motivation of subsidiaries to breach contracts for personal gain. Based on the widely accepted rule that when corporate formalities are followed, initial financing is sufficient, and the company is not formed to defraud creditors or other third parties, the corporate form will be respected, shareholders will be respected, and shareholders will not be liable for corporate debts and liabilities, the term "corporate veil" refers to the limited liability of a company. As a result, when courts "lift" or "pierce" the corporate veil, they reject the company's independence and hold a shareholder accountable for its decisions as if they were their own. By removing the corporate veil, one may see the true nature of the business beneath the legal façade and stop members from acting irresponsibly because they have personal financial interests. Or the court will pierce the veil if it has reason to believe, according to Sections 34 and 38 of The Companies Act, 2013, that the corporate identity is being utilized as a cover for fraud or criminal activity.

CASE LAWS

There are two instances of lifting of the corporate veil: statutory and judicial. It is referred to as Statutory Lifting if the corporation breaches the Companies Act, of 2013, and the act allows for the lifting of the veil for the same. The latter is when the company has breached the Companies Act, 2013 but the legislation doesn't provide for the veil to be lifted in the given circumstance leaving the judiciary to take matters into their own hands.

However, certain instances can be pointed out when the corporate veil has been lifted due to the nature of the transgression.

1. **To determine the character of the company in times of war, i.e., to ascertain whether the company is friend or foe**

Case: *Daimler Co. v Continental Tyre and Rubber Co.*[11]

[11] *Daimler Co v Continental Tyre & Rubber Co* [1916] 2 AC 307

Facts: A corporation was formed in England to sell tyres produced in Germany by a German company. Except for one shareholder who was a naturalized British citizen but was born in Germany, the stockholders were all German. Following the start of the First World War between England and Germany, Continental Tire, a German corporation, refused to pay any money, arguing that doing so would violate the 1914 Trading with Enemies Act.[12] The secretary of state took legal action against Continental Tire. The German corporation won the same judgement, proving that it possessed a hostile personality. The secretary appealed the court of appeals ruling to the house of lords.[13]

Issues: If removing the corporate veil may be employed in crises, whether paying the debt would constitute trade with the enemy, and whether the corporation was an alien entity.

Ruling: The House of Lords accepted the appeal and determined that even though the firm is a separate artificial entity from its owners, it will take on an enemy character if its shareholders or controlling agents are citizens of an enemy nation. When there is peace or no war, the court believed that the character of individual shareholders cannot affect the character of the company. However, during a war, it is important to take into account any agents or people who are following orders from such shareholders who are from an enemy nation to assess the character of the company as a whole. Because the secretary only owns one of the company's 25000 shares, which are from England, and the rest are from Germany, the court strongly held that it is the responsibility of the company to demonstrate that the secretary was not acting on instructions from other shareholders from an enemy nation. The court's finding that the shareholders' behaviour and character can affect the firm's choices and give the corporation an enemy character if shareholders from that nation are in charge of making such decisions is the ratio decidendi in this case.[14]

2. To uncover tax fraud and protect revenue:

[12] Trading with Enemies Act 1914
[13] *Ibid*
[14] *Daimler* (n 11)

Case: *In Re: Sir Dinshaw Maneckji Petit Bari*[15]

Facts: Four private limited businesses were created by Mr. Dinshaw. Except for three shares owned by those under him, he was the sole owner of every share. Companies were just taking dividend payments and lending them back to the assessee as loans to lower his super tax bill.

Issue: Whether the business was the business of the companies themselves or the assessee and whether the corporate veil of the company can be lifted to determine the question of tax liability.

Ruling: It was determined that the corporation was fraudulent in every way, but that the assessee had posed as the limited company's legal representative and that the stated loans were false. The corporate veil was hence pierced.[16]

3. To avoid a legal obligation

Case: *Workmen Employed In Associated Rubber Industries Vs Associated Rubber Industry Ltd*[17]

Facts: The respondent owned shares in NARCO Ltd., through which Associated Rubber Industry earned yearly dividends. The dividend was taken into account while determining the bonus that was to be paid to the workers. In 1968, the business transferred the shares it owned to Aril Holdings Ltd, a wholly-owned subsidiary of the Associated Rubber Industry. Except for earning dividend income on the shares of NARCO Ltd., Aril Holdings Ltd. lacked any assets or income sources. The employees of Associated Rubber Industries Ltd. argued that by shifting the dividend amount to the subsidiary firm, the new subsidiary company was created to give smaller incentives to employees. The workers argued that instead of the 4% bonus that was given to them, they were entitled to one at a rate of 16%. The Aril Holdings Ltd. earnings could not be considered as profit, according to the Industrial Tribunal and the High Court of Gujarat, which found that the two organizations were separate legal entities.[18]

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[15] *In Re: Sir Dinshaw Maneckji Petit Bari* AIR 1927 Bom 371
[16] *Ibid*
[17] *Workmen Employed in Associated Rubber Industries v Associated Rubber Industry Ltd* AIR 1986 SC 1
[18] *Ibid*

Issue: Can the companies Aril Holding Ltd and Associated Rubber Industry Ltd be recognized as different legal entities and is the claim made by the workers that the shares were transferred to evade bonus payment tenable?

Ruling: Citing the decision in Commissioner of Income Tax Madras v Sri Meenakshi Silks Ltd.,[19] it was determined that even though the company is a separate legal entity from its members and is entitled to certain rights, the corporate veil may be lifted in rare circumstances to reveal the person who committed a crime. Citing further the case of Mc Dowell and Company Limited v Commercial Tax Officer, in which it was decided that the court should decide on various legal strategies used to avoid taxes, the Supreme Court noted that the primary company created a wholly owned subsidiary with no assets or business income but only to receive dividends, which indicated the fact that it was created to reduce gross profits. The Supreme Court noted that neither direct nor indirect evidence was necessary to prove that the company's formation had the goal of lowering the incentive payments made to employees. The Supreme Court determined that the amount of dividend received from INARCO Ltd. should be taken into account when calculating the gross profit of Associated Rubber Industry Ltd. to determine the bonus that is due. In addition, the Supreme Court ruled in favour of the appeal and mandated that the workers get a 16% bonus for the year 1969.[20]

4. Formation of subsidiaries to act as an agent:

Case: *Merchandise Transport Limited v British Transport Commission*[21]

Facts: In this instance, the main company, Merchandise Transport Limited, a transport company, applied to the British Transport Commission for a license for one of its vehicles. However, for some reason, the British Transport Commission rejected the application, so the company going by that name was unable to apply. To get a license for its vehicle, Merchandise

[19] *Tax Madras v Sri Meenakshi Silks Ltd* 1967 AIR 819
[20] *Ibid*
[21] *Merchandise Transport Ltd v British Transport Communications* [1982] 2 QB 173

Transport Limited established a subsidiary firm. Here, the British Transport Commission denied the license application.

Ruling: The subsidiary firm didn't do any business or generate any revenue, the court discovered. Both businesses were working toward the same goal because the same was only founded to secure the licenses. As a result, they were recognized as one economic unit.

5. **Companies formed for purposes of fraud, improper conduct, or defeating provisions of law:**

Case: *Gilford Motor Company v Horne*[22]

Facts: The registered office of Gilford Motor Co Ltd was located on Holloway Road in London. Mr. Horne served a six-year tenure as a former director of the plaintiff corporation. He was let go before the term was through. A non-compete provision (9) in his employment contract forbade him from approaching the company's clients. However, following his dismissal, he founded J.M. Horne & Co. Ltd, a business that offered to price lower than Gilford Motor Co. Additionally, he reached out to the clients he had met while working for Gilford. Additionally, he circulated circulars stating that the defendant was prepared and, in a position, to provide spare parts for Gilford cars to a variety of customers. Gilford could not sue Holmes since the contract was with Holmes because a firm has a different legal personality. He asserted, however, that Mr. Holmes's acts were covered up by using the corporation as an "instrument of fraud."[23]

Issue: Whether the defendant violated the contract by using the corporation as a shield?

Ruling: According to the High Court, Defendant did not violate his contract. Since it was obvious that the main reason a company was founded was to commit fraud, the Court of Appeals held the opinion that "the company was formed as a device, a stratagem, to disguise the effective carrying on of the business of Mr. Horne." The covenant "was not larger than was reasonably necessary for the protection of the plaintiff company's trade and was thus

[22] *Gilford Motor Company v Horne* [1933] Ch 935
[23] *Ibid*

enforceable by injunction," the court stated in response to the defendant's request. It is clear that the defendant Horne is solely responsible for running the defendant's business. It served as how the defendant, Horne, conducted his business. It was decided that the new corporation was nothing more than a ruse or disguise that allowed the defendant to break the terms of the contract. Lord Handsworth subsequently awarded the defendant's company an injunction.

CONCLUSION

A business is granted the right to exist independently of other legal entities under the 2013 Companies Act. Since it is assumed that they won't be held responsible or personally liable for the company's conduct, the majority of people's primary motivation for forming their corporation under the act is the aforementioned privilege. Additionally, it gives people a sense of security that enables them to engage in lucrative endeavours that would otherwise be rejected as being "high-risk." Piercing of the corporate veil as a concept enables disarming powerful forces that would misuse power, position, and statutory immunity for personal gain and dent the strides made by the economy of the country. As a dynamic concept, it reigns corporations and their members from virtual autonomy and binds them by accountability. One of the finest pieces of legal fiction, Piercing of Corporate Veil as a concept is pertinent to ensuring a just, transparent, and efficient financial ecosystem.