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## Blurring of Lines between a Company and Its Members in Light of the Doctrines of Piercing and Reverse Piercing of Corporate Veil

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*The separate legal entity is arguably one of the most important and cardinal principles of Company Law. By stating that the company is a different entity than its members, shareholders and directors, each company could acquire property, sue, be sued, and most importantly, limit the liability of its members. These characteristics have, in consequence, led to a massive spurt in companies. Yet, this principle has served as an easy way out for various scamsters, as they incorporate companies, and use it as a medium to commit fraudulent activities. They use the corporate legal identity as a cloak and escape personal liability. As this practice grew, courts decided to condone the same by evolving the Doctrine of Veil Piercing, where the otherwise immune members and directors of a company could be held personally liable for the acts committed by the company, when it was, in fact, them who used the company as a facade. To further, ensure equity, the principle of reverse piercing, where a company's assets are used to remedy the claims of claimants and creditors against the controlling members of a company, i.e. a company being held liable for the acts of its members. Though these doctrines seem to be effective, they are digressive, with no consistent application. This has led to various circumstances where both companies and claimants have had to bear the brunt of the inconsistencies of these doctrines. This paper examines the importance of the corporate identity, as well as veil-piercing doctrines, and tries to arrive at a middle ground, to ensure a balance of interests, as well as provide equitable and just remedies to disputing parties.*

**Keywords:** *separate legal entity, piercing of corporate veil, reverse piercing of corporate veil.*

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## INTRODUCTION

One of the cardinal principles of corporate law is that a company is separate and independent from its members and directors. After incorporation, all companies are entrusted with various powers, including that to hold and dispose of property, the right to sue and be sued, and perpetual succession. It is this corporate identity of a company that provides the members of a company with limited liability, which in turn is one of the key reasons for the rapid growth of companies. This principle came to be challenged as companies grew, and new legal complications arose. Many companies were created with the intent to defraud creditors, to avoid liabilities, and to operate as mere shams for the owners and members of such companies. It was in light of these developments that the doctrine of piercing the corporate veil evolved, which fastened liability on immune members of a company for the acts done by the company. The insufficiency of this doctrine led to the evolution of doctrine or reverse piercing, where a corporation's assets could be used to satisfy claims against the companies' shareholders and members.

These doctrines have been questioned for lack of clarity and uniformity, which consequently challenged the effectiveness of these doctrines. On the other hand, the absence of these doctrines would lead to increasing corporate scams and frauds going unchecked. Hence, the burden of balancing the claims of the members of a company, as well as the claimants against the company falls squarely on the court. This paper attempts to make sense of the haphazard application of the doctrines and to provide basic safeguards to ensure that both the company's interest and the claimant's interests are protected.

## SEPARATE LEGAL ENTITY AND ITS IMPLICATIONS

It is a well-established principle in corporate law jurisprudence that a company is a separate person, distinct from its members. The word company does not have a legal meaning, and is

only defined as ‘a company incorporated under the Companies Act 2013 or under any previous company law.’<sup>1</sup> Many jurists have defined it as an artificial person created by law, which is invisible, intangible, and only present in the eyes of the law. A company is, like any juristic person, an entity apart from its members, having rights and duties of its own, and possessing perpetual succession.<sup>2</sup> The same has been authorised by Sec 9 of the Companies Act<sup>3</sup>, which confers a few powers to a company that has been incorporated including that to hold and dispose of property and to sue or be sued in its registered name after the company is incorporated.

The oft-quoted *Salomon v Salomon*<sup>4</sup> pioneered in establishing the separate identity of a company. The House of Lords held that a company is a ‘legal person’ or ‘legal entity’ separate from, and capable of surviving beyond the lives of its members. The liability of a company could not be chained on its members, and once incorporated according to law, the liability of the members of a company is limited only to what they undertake, and anything else explicitly mentioned in the law. The *Kondoli Tea Estate case*<sup>5</sup> too was decided similarly. When the owners of a tea estate wanted to transfer it to a company to which the same owners were shareholders, they treated it as if no transfer had taken place to avoid payment of tax. However, the court held that even if the owners of the estate and the shareholders of the company were the same people, the company was a separate entity from its shareholders, hence there was a transfer, and the consequent tax ought to be paid.

Further developments and a catena of precedents show a similar trend, where courts have vehemently opined that the members of a company do not constitute the company and that it has a corporate legal identity of its own, which is distinct, independent and separate from its members. The importance of this principle lies in the fact that the separate corporate identity of

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<sup>1</sup> Companies Act 2013, s 2(20)

<sup>2</sup> ‘Hahlo’s Casebook on Company Law by H. R. Hahlo, M. J. Trebilcock; Charlesworth and Cain’s Company Law T. E. Cain’ (1989) 38(2) The Cambridge Law Journal <<https://www.jstor.org/stable/4506209>> accessed 15 November 2023

<sup>3</sup> Companies Act 2013, s 9

<sup>4</sup> *Solomon v A Solomon & Co Ltd* [1897] AC 22

<sup>5</sup> *In re Kondoli Tea Co. Ltd.* (1886) ILR 13 Cal. 43

a company gives rise to various other fundamental characteristics of a company, including limited liability, perpetual succession, and others as provided in Sec 9 of the Companies Act<sup>6</sup>.

Limited Liability lies at the core of a company, and is one of the most important reasons for the commercial prosperity of the country, and the rapid growth of companies, as stated by Buckley J<sup>7</sup>. As opposed to partnerships and sole ownerships, personal liability is absent, and the liability of the members is only to that extent as undertaken by them in case of winding up of the company<sup>8</sup>, or that amount unpaid on shares held by them<sup>9</sup>. It is well-accepted that this concept of limited liability is the primary motivation for the incorporation of companies, and upholding this character is essential for the continuation and growth of corporations.

The perpetual succession found in a company is also a direct derivative of a company's separate identity. As the members and the company are distinct, the company will continue to exist, despite change, insolvency or even the death of its members. Gower<sup>10</sup>, taking inspiration from Lord Tennyson's 'The Brook' writes 'Members may come and go but the company can go on forever.' This principle further strengthens the concept that a company's identity is not linked to its members. Moreover, a company can hold and dispose of property in its own name, and the members of a company cannot be held as interested parties concerning the company's property. This was upheld in *Macaura*<sup>11</sup>, where the majority shareholder of a company insured timber of the company in his name, and in the event of the timber getting destroyed, he could not claim the insurance. This was because shareholders do not have a true and equitable claim on the property of a company, a position of law that has been upheld yet again via various precedents.

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<sup>6</sup> Companies Act 2013, s 9

<sup>7</sup> In re *London & Globe Finance Corpn Ltd* (1903) 1 Ch 728

<sup>8</sup> Companies Act 2013, s 2(21)

<sup>9</sup> Companies Act 2013, s 2(22)

<sup>10</sup> L.C.B Gower, *Principles of Modern Company Law* (1969)

<sup>11</sup> *Macaura v Northern Assurance Co Ltd* [1925] AC 619

It has even been opined<sup>12</sup> that it is an objective fact that a corporation is a person, and all that law does is grant legal recognition to the same fact. However, it is beyond question that when the legality of a company has been established, it is definitely a separate entity different from its members. Although a corporate personality is a legal fiction, the entity personified is not fiction. So, the separate corporate personality of a company cannot be disregarded as mere fiction, as it is fiction based on fact. The recognition of this right becomes all the more important when the various rights flowing directly out of the corporate personality theory are taken into consideration, and these bundles of rights and advantages form the essential features of any company.

### **VEIL PIERCING DOCTRINES- AN ANTITHESIS TO SEPARATE IDENTITY?**

Though it is one of the fundamental principles, the corporate personality theory has been used by the directors and members of a company to escape liability, stating that they could not be held responsible for the acts that were done by the company, a separate legal person. It was to rid this mischief that courts evolved the doctrine of piercing of corporate veil, one by which the otherwise immune officers of a company are made liable for the acts done by the company. This principle took away the sacrosanct status of the corporate identity principle to ensure that reality was not disregarded. There are statutory provisions and many non-statutory instances considered by the court as well, to call for the lifting of the corporate veil of a company.

#### **The statutory provisions include:**

1. *Sec 3A*<sup>13</sup>, which imposes personal liability on members on the debt of a company that carries out business for more than six months without the requisite number of members required statutorily, provided the other members were cognisant of the same.

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<sup>12</sup> Arthur W. Machen Jr., 'Corporate Personality' (1911) 24 Harvard Law Review  
<<https://heinonline.org/HOL/LandingPage?handle=hein.journals/hlr24&div=29&id=&page=>> accessed 12 November 2023

<sup>13</sup> The Companies (Amendment) Act 2017, s 3A

2. *Sec 464*<sup>14</sup> imposes personal liability on members of a company that has an association of members exceeding the statutory limit of 100 persons
3. *Secs. 34*<sup>15</sup> *and 35*<sup>16</sup> of the act impose criminal and civil liability for misstatements in the prospectus, and the promoter, director and any other such person authorised to issue the prospectus shall be held liable.
4. For a misdescription of the name of the company in a contract against what is required under *Sec 12*<sup>17</sup>, the persons that have entered the contract will be held liable
5. *Sec 339*<sup>18</sup> imposes liability for fraudulent conduct of a company's business, and in the course of winding up of business, the tribunal can hold any party liable for the misconduct, as it deems fit.
6. *Sec 39*<sup>19</sup> provides that the directors and promoters of the company are responsible for returning the application money to the applicants if the minimum subscription money is not received.

Courts have pierced the corporate veil in various non-statutory instances. In the *LIC v Escorts case*<sup>20</sup>, a constitutional bench of the Supreme Court mentioned some of these instances, like prevention of fraudulent conduct, tax evasion, and evading beneficial statutes among others.

**To determine the character of a company:** At times of war, a court lifts the veil of a company to ascertain the managing personnel of a company, to ensure that they are not alien enemies. If the inquiry yields an affirmative result, the company will too be treated as an alien enemy, and will

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<sup>14</sup> Companies Act 2013, s 464

<sup>15</sup> Companies Act 2013, s 34

<sup>16</sup> Companies Act 2013, s 35

<sup>17</sup> Companies Act 2013, s 12

<sup>18</sup> Companies Act 2013, s 339

<sup>19</sup> Companies Act 2013, s 39

<sup>20</sup> *LIC v Escorts Ltd.* (1984) SCR 3 643

not be allowed to do such acts that may prejudice the security of that nation, like calling money for debts issued, as in the *Daimler Company case*<sup>21</sup>.

**For the benefit of revenue:** When courts enquire and find that companies are created merely for revenue benefit, and no other equitable cause exists behind the incorporation of such a company, the separate identity of the company is disregarded. The same was illustrated in the *Dinshaw Petit Case*<sup>22</sup>, where the defendant created four companies to avoid paying tax for the dividends he received. In such cases, there is no ‘veil’ separating the company and the person, and hence the veil is pierced.

**To check fraud or improper conduct:** Moreover, courts have taken to lifting the veil when it is evidenced that a company is formed with the sole intent to carry on fraudulent activities. When a company was formed to avoid the completion of the sale of a defendant's house, it was held that the company was a sham, and was the same as the defendant<sup>23</sup>. A similar decision was arrived at in *Gilford Motor Co. v Horne*<sup>24</sup> when Horne incorporated a company to solicit customers, which he was incompetent to do due to a non-compete clause he signed with his previous employers. As the only purpose of the company was to indirectly do something the defendant was barred from doing, the company was used as a mere sham, and the same was stopped.

**Companies avoiding legal obligations:** If a company is formed with the intent of avoiding a legal obligation, then those companies will not be regarded as separate entities, and the veil will be pierced in that case. In the *Rubber Industry case*<sup>25</sup>, when a company created a subsidiary and transferred certain income to avoid paying bonuses to its workmen, the court took no hesitance in piercing the corporate veil.

In addition to the traditional theory of veil piercing, owing to the fast-paced development of corporations, courts have gone a step further and evolved the Doctrine of Reverse Piercing of

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<sup>21</sup> *Daimler Co Ltd v Continental Tyre & Rubber Company* (1916) 2 AC 307

<sup>22</sup> *In re Dinshaw Maneckjee Petit* AIR 1927 Bom 371

<sup>23</sup> *Jones v Lipman* [1962] 1 WLR 832

<sup>24</sup> *Gilford Motor Co. v Horne* 1933 Ch 935

<sup>25</sup> *Workmen v Associated Rubber Industry Ltd* (1985) 4 SCC 114

the corporate veil, where either the creditors or even the corporation owners seek to make a corporation liable for the debts of its shareholders. When third-party creditors invoke this doctrine, it is termed 'Outsider Piercing' and when invoked by insiders in the company, it is 'Insider Piercing'. This doctrine was primarily evolved in the US, and in India, the SC opined that this doctrine can be used only when it is evident that the company exists as a mere sham, created by the controllers of the company to avoid liability.

One of the first cases of reverse piercing, which was voluntarily sought by the owner of the corporation, was in *Macaura*<sup>26</sup>, but the same was denied. To date, UK Courts have been reluctant to apply this doctrine, and have used it only in the rarest of rare circumstances<sup>27</sup>. However, the US has been the leading jurisdiction in reverse piercing cases and has evolved various tests. The alter-ego doctrine, which provides that if the owner of a company has control and domination over a company, reverse piercing could be allowed was laid down in the *Platts case*<sup>28</sup>. In the *Easton case*<sup>29</sup>, it was affirmed that the commission of fraudulent acts would be an added ground, and the direction of the pierce would be irrelevant.

This doctrine was recognized by the Supreme Court in *Standard Chartered Bank v Directorate of Enforcement*<sup>30</sup>, where it observed that a corporation could be prosecuted for an offence despite the mandatory statutory punishment on behalf of its owners. In *Aneeta Handa & Ors v God-father Travels*<sup>31</sup>, the Court further observed that with respect to section 141 of the Negotiable Instruments Act, 1881, where a person or a group of persons guiding the business of a company do so with a criminal intention, the same shall be imputed to the body corporate and not vice-versa. So, though not explicitly stated by courts, the court has used the doctrine of reverse piercing of the corporate veil.

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<sup>26</sup> *Macaura v Northern Assurance Co Ltd* 1925 AC 619

<sup>27</sup> Gautam Bhatia, 'Comparative Look at Reverse Piercing of Corporate Veil across Jurisdictions' (2023) 3(1) Indian Journal of Integrated Research in Law <<https://ijirl.com/wp-content/uploads/2023/02/COMPARATIVE-LOOK-AT-REVERSE-PIERCING-OF-CORPORATE-VEIL-ACROSS-JURISDICTIONS.pdf>> accessed 12 November 2023

<sup>28</sup> *Platts Inc. v Beatrice Platts* [1956] 49 Wn.2d 203

<sup>29</sup> *Easton v State of New York* 153 Misc. 395

<sup>30</sup> *Standard Chartered Bank v Directorate of Enforcement* (2006) 4 SCC 278

<sup>31</sup> *Aneeta Hada v M/S Godfather Travels & Tours (P) Ltd.* (2012) 5 SCC 661



## BALANCING COUNTERCLAIMS- THE VIGILANT PATH TO JUSTICE

It has now become undisputed that in today's day and age, corporations have been increasingly getting away with various unlawful activities, and a serious check is necessary. Though there is *prima facie* evidence to show that the doctrines of piercing and reverse piercing of the veil suffice in tackling the mischief, these doctrines are riddled with problems.

Courts have time and again tried to lay down various guidelines in various cases, yet they continue using terms like 'sham' or 'façade' without actually providing insight into the factors considered by courts. Even the Supreme Court has observed in *Balwant Rai Saluja*<sup>32</sup> that there was no clarity on the application of the said doctrine.

A recent authority that provided six principles for piercing were given in *Ben Hashem v Ali Shayif*<sup>33</sup> which:

1. Ownership and control were not sufficient grounds for piercing;
2. Interest in justice is not a sufficient ground for piercing;
3. Only when an impropriety is present, can the veil be pierced;
4. The impropriety must be connected to the use of the company as a sham;
5. The controllers of the company should have indulged in impropriety, and the company must be used as a sham in the process;
6. The character of the company is relevant only when it is used to prove that it was a 'façade' at the time of conduct of impropriety.

Piercing of the corporate veil has been statutorily authorised only in select cases, and in other circumstances, courts have applied this doctrine to ensure an equitable remedy. However, the same has been an arena of criticism, from authors to judges. Justice Cardozo's observation that the doctrine of veil piercing was *enveloped in the mists of metaphor*<sup>34</sup> has been the focal point of the various critiques, and the observation of the UK Supreme Court in *Prest v Petrodel*<sup>35</sup>, where it

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<sup>32</sup> *Balwant Rai Saluja v Air India Ltd.* (2014) 9 SCC 407

<sup>33</sup> *Ben Hashem v Ali Shayif* [2008] EWHC 2380

<sup>34</sup> *Berkey v Third Ave. Ry.* 244 N.Y. 84

<sup>35</sup> *Prest v Petrodel*, UKSC 34, 4 All ER 673

opined that this doctrine has been wrongfully applied in many cases proves Just. Cardozo's point firmly.

Moreover, it has been pointed out that for a similar set of facts, the outcomes have been diametrically opposite, in piercing cases. There lie contradictory opinions regarding piercing when companies have been incorporated for the sole purpose of avoiding liability, as has been in cases of inadequate capitalisation. Hence, various authors conclude that even though similar factors are present in all cases where the lifting of the veil is sought, the impact and degree of importance each factor will be given cannot be measured, and hence, the outcome cannot be determined.

Nonetheless, as most veil-piercing cases are highly fact-specific, no number of principles or rules can provide adequate generalisation in this regard. Hence, it is felt that the exercise of laying down rules in an area that is riddled with ambiguity, unpredictability, and even randomness is considered futile. This is the root cause of veil-piercing cases being compared to lightning, as they occur rarely, fast, severe and unprincipled.<sup>36</sup> The contradicting judicial opinions, including various internal inconsistencies in a single judgement<sup>37</sup>, have made it unclear whether veil piercing was a norm or an exception. The problem of uncertainty lies deeper in the case of reverse piercing, which has been discussed and applied sparingly compared to the veil piercing doctrine.

The very first step to ensure that the separate identity of a company is not compromised is to keep veil piercing and reverse piercing as the last remedy after all other alternate remedies are exhausted. The Delhi High Court<sup>38</sup> also recently observed that when there is an efficacious alternative remedy, courts can refuse to entertain discretionary jurisdiction. It has been noted that in many veil-piercing cases in the US, direct action against an individual shareholder could

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<sup>36</sup> Frank H. Easterbrook and Daniel R- Fischel, 'Limited Liability and the Corporation' (1985) 52(1) The University of Chicago Law Review <<https://chicagounbound.uchicago.edu/uclrev/vol52/iss1/3/>> accessed 12 November 2023

<sup>37</sup> *DeWitt Truck Brokers, Inc. v W. Ray Flemming Fruit* 540 F.2d 681

<sup>38</sup> *Wave Hospitality (P) Ltd. v Union of India* (2019) SCC OnLine Del 8855

have been brought<sup>39</sup>. Hence, the exhaustion of all other legal remedies must be enforced mandatorily to bring about optimal outcomes. India has followed the principles of UK law and has applied this doctrine in a restrictive manner.

Undoubtedly, cases where the piercing of the veil is needed will arise, and in those cases, courts will have to exercise caution. Though it has been established that a set of definitive principles governing piercing would be implausible to arrive at, certain non-negotiables, like those laid down in the Hashem case have to be followed. Additionally, it has been argued that in lieu of these doctrines being those of equity, they must be reconceived as constructive trusts. In a constructive trust, i.e. when misappropriated assets are disgorged from parties that are unjustly enriched.<sup>40</sup> It has been stated that conceiving veil piercing cases to be of this nature would simply ensure that the company or any member of the company is not unjustly enriched at the cost of any innocent creditor, or other claimant (the former pertains to reverse piercing, whereas the former to piercing of veil.) This doctrine of a constructive trust was ‘the formula through which the conscience of equity finds expression’, in the words of Justice Cardozo.<sup>41</sup> Many have argued against the principle of veil piercing on the grounds as stated, that it is ambiguous and that there are no specific identified criteria to pierce the veil. The constructive trust doctrine simplifies the factors to be considered and has better results than superior veil piercing.<sup>42</sup>

However, this method of piercing has yet to be considered by courts, it would provide effective and equitable results. The need of the hour is the crystallisation of law around piercing and reverse piercing of the veil, for these are the most litigated areas in corporate law, yet the least understood.<sup>43</sup> Only when there is an all-encompassing, comprehensive pronouncement on the

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<sup>39</sup> Franklin A. Gevurtz, ‘Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil’ (1997) 76 University of the Pacific scholarly Commons <<https://scholarlycommons.pacific.edu/cgi/viewcontent.cgi?article=1186&context=facultyarticles>> accessed 12 November 2023

<sup>40</sup> Peter B. Oh, ‘Veil-Piercing Unbound’ (2013) 93 Boston University Law Review <<https://www.bu.edu/law/journals-archive/bulr/volume92n4/documents/OH.pdf>> accessed 12 November 2023

<sup>41</sup> *Beatty v Guggenheim Exploration Co.* 122 N.E. 378

<sup>42</sup> *Balwant Rai Saluja v Air India Ltd.* (2014) 9 SCC 407

<sup>43</sup> Robert B. Thompson, ‘Piercing the Corporate Veil: An Empirical Study’ (1991) 76(5) Cornell Law Review <<https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=3501&context=clr>> accessed 12 November 2023

scope and applicability of these doctrines, will all the uncertainty fade away. Though there have been various amendments in Company Law, only certain specific grounds with regard to piercing are present, and there is no mention of reverse piercing. Hence, a legislative authority via an amendment is an urgent necessity, which will streamline various circumstances, and provide uniform grounds for piercing.

## CONCLUSION

The pace of growth of companies is rapid, yet not unprecedented. This growth can be attributed to the limited liability principle due to which the liability of the members and shareholders are restricted. It stems from the concept that a company and its members are distinct, i.e. the separate legal entity theory. And, this makes sense<sup>44</sup>. However, the mischief arose when the principle of corporate entity was being used as a veil and a mere facade to incorporate companies that were created simply to defraud creditors and avoid legal liabilities, all for the personal gain of its members and owners. To ensure that these fraudulent motives did not succeed, the doctrines of piercing and reverse piercing of the corporate veil were evolved by courts. However, the ambiguity surrounding them, and the contradictory application of these doctrines have been heavily criticised, to the extent that many scholars write for the abolition of the same. In spite of this, in the absence of these doctrines, the misappropriations of many corporations would go unchecked. So, it becomes necessary that these doctrines are retained, but are streamlined and regulated to ensure that they can be applied fairly and consistently. For the same, it is suggested that the courts ensure strictly that veil piercing is applied only when there is no alternate remedy. Courts must lay down certain non-negotiable principles for piercing to happen, but just ensure that this list does not become a laundry list. Moreover, Indian Courts can apply the principle of constructive trust to ensure that the claims of genuine claimants are satisfied. In this regard, any legislative authority, by way of rules, regulations or bylaws that stem from research on this topic, that provides a regulatory framework on piercing

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<sup>44</sup> Stephen M. Bainbridge, 'Abolishing Veil Piercing' (2000) SSRN  
<[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=236967](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=236967)> accessed 12 November 2023

and reverse piercing would be welcome and is the need of the hour. Only when there is no ambiguity in applying these doctrines will they be workable and equitable.