

**LIFTING AND REVERSE LIFTING OF THE CORPORATE VEIL****\*RITIKA CHAUHAN****INTRODUCTION**

It is textbook law that a shareholder and his company are two different people in the eyes of law. While a shareholder is a natural person, the company too is an artificial person with its own rights and liabilities. This is essentially the doctrine of separate legal entity and forms the cornerstone of the Indian corporate laws<sup>1</sup>. A doctrine such as this is pervasive i.e. present in most legal systems around the world.

The doctrine of separate legal entity is limited by lifting of the corporate veil. This veil separates a company from its members. When the Courts partially or completely disregard this veil, it is termed as 'lifting of the corporate veil'. This is when a company, instead of being considered as an artificial person on its own, is looked at like an association of natural persons.

One of the relevant cases of lifting of the veil that had been much talked about in India was the famous case of *Vodafone International Holding v. Union of India*. In this significant case, the Indian judiciary had deliberated over the issue of corporate veil and finally come to the conclusion that lifting the corporate veil was unnecessary in the given case.

While 'lifting of veil' exists to prevent the shareholders from hiding behind the corporation, a 'reverse lifting of the veil' was also formulated to expose a corporation to liability for the acts done by one of its members.

In the following research paper, the author shall focus on the concept of lifting of the corporate veil along with the way it has been dealt with by the Courts over the many years since its conceptualisation. The author will then move on to the antithesis to the above-mentioned i.e. reverse lifting of the corporate veil. While this concept is fairly new and much has not been said on it, it is an interesting aspect of corporate law that has remained unemployed in the Indian legal system since the beginning. The paper attempts to understand the need for such a concept and the way it is being dealt with by the Courts, almost rejecting it.

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<sup>1</sup> Shashank Bijapur and Tulika Sinha, "Piercing the Corporate Veil, A Primer" Vol. 3 KLJ 1 (2008)

## SEPARATE LEGAL PERSONALITY OF A COMPANY

The most basic attribute of any corporate is its distinct legal personality or identity. In most cases, it forms the quintessential basis for choosing this form of business as compared to sole proprietorship and partnership. This attribute further gives rise other characteristics of a corporate such as:

- Capacity to sue or be sued
- Capacity to enter contracts in its own name
- Perpetual existence of the company
- Limited liability of the shareholders

According to this doctrine of separate legal entity, all corporates have a personality that is independent of its shareholders. There is a metaphorical ‘veil’ between the corporate and its shareholders. This metaphorical veil is known as the ‘corporate veil’.

The use of the term ‘veil’ was first seen in the American courts. It has been supported equally in the common law jurisprudence as well as civil law jurisprudence. One of the main reasons this concept was readily adopted in several legal systems is the socio-economic benefit attached to it. On one side, it provides a safe environment to investors to invest in a variety of ventures because of their limited liability and on the other side, the corporates are able to gather high amounts of capital that allows to them make high investments in innovation, technology and infrastructure. The concept of ‘corporate veil’ aids the economy of a country at the end of the day.

Corporates as separate legal entities were first recognized in the landmark case of *Solomon v. Solomon and Co.*<sup>2</sup> Solomon was a manufacturer in the leather industry. He incorporated a company and sold his entire business to that company in consideration for debentures worth 10 thousand pounds and six shares. Each share was given to wife and five sons respectively. When Solomon Co Ltd. went into liquidation, Solomon claimed his returns on the debentures as a secured creditor. However, the liquidator denied his claim as in his view, Solomon and the company were one entity and the company carried out business on Solomon’s behalf.

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<sup>2</sup> *Salomon v. Salomon & Co. Ltd.* [1897] A.C. 22.

The House of Lords held that Solomon and Solomon Co Ltd. were two separate legal entities. It was held that although the incorporation of the company brought no significant changes to the functioning of the company or the profit distribution order, the company was still an independent entity with its own right and liabilities.

This same concept was later recognised in the case *Macaura v. Northern Assurance Co. Ltd*<sup>3</sup> wherein it was decided that the plaintiff, a shareholder of a company, was not to receive an amount of insurance from the insurers as it was the company that owned the property as a separate legal owner and not the plaintiff.

Another case that explains the concept is *Lee v. Lee's Air Farming*<sup>4</sup>. In this case, it was held that Lee and the company Lee's Air Farming were different entities. Lee was an employee of the company and his wife was held to be eligible to claim worker's compensation after his death.

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<sup>3</sup> *Macaura v. Northern Assurance Co. Ltd.* [1925] A.C. 619

<sup>4</sup> *Lee v. Lee's Air Farming* [1961] A.C. 12

## LIFTING OF THE CORPORATE VEIL

HISTORY

The doctrine of separate legal entity was first applied in the *Saloman case*. From 1897 to 1966, the Courts experimented with the idea of corporate veils.

While the concept of 'corporate veil' was justified by its economic benefits, it was also used to indulge in fraudulent practices by the persons behind the veil. As a result, exceptions to separate legal entity were identified. The main reason behind this was that although corporations are separate legal persons, they are still artificial persons. This means that a corporation could not be held liable for committing a tort or any crime requiring *mens rea* which provided a perfect shield to some shareholders or director who did commit a crime<sup>5</sup>. Another reason is that if the concept of 'corporate veil' is taken so seriously, it would lead to unjust or misleading attempts to hide behind the veil of limited liability.

Therefore, in the case of *Littlewoods Mail Order Stores Ltd. v. IRC*<sup>6</sup>, Lord Denning observed that incorporation of a company does not cast a veil that law cannot see through. In an American case, it was further noted that while a corporation is a separate legal entity, this notion can be set aside if there has been any public inconvenience, public wrong, fraud or any other such crime<sup>7</sup>. This is the first instance of lifting of the corporate veil.

In 1989, with the case of *Woolfsan v. Stratheclye*<sup>8</sup>, the English Courts became very critical of the corporate veil. In this case the Court held that a corporate veil could be completely ignored if it is established that the company was incorporated for any purpose other than commercial purposes. In matters succeeding this case, the Courts have taken a very narrow view of the doctrine of corporate veil.

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<sup>5</sup> P.M. Bakshi, "Lifting the corporate veil." CIJ, vol. 1, 1989, p. 2

<sup>6</sup> *Littlewoods Mail Order Stores Ltd. v. IRC* [1969] 1 W.L.R. 1241, 1254

<sup>7</sup> *United States v. Milwaukee Refrigeration Transit Company* 142 F.247 (1906).

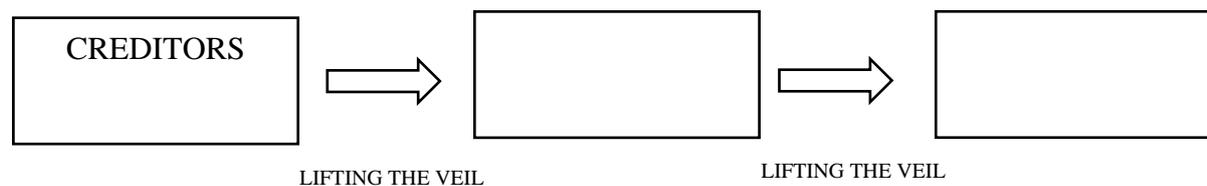
<sup>8</sup> *Woolfsan v. Stratheclye* (1978) SLT 159

### BASIC CONCEPT

According to the definition given by Black Law's Dictionary<sup>9</sup>, lifting of the corporate veil is referred to as an act of the judiciary by which liability is imposed on the otherwise immune shareholders, directors, etc for the wrong committed by their corporation.

'Lifting of the corporate veil' is the most widely applied, discussed and litigated doctrine in relation to companies. It simply means disregarding the separate legal identity of a corporation and identifying the actual persons behind a particular action of the corporation. The doctrine of lifting the corporate veil is applied in cases wherever the Courts feel that the legal identity of a company is fraudulently or dishonestly used by an individual or group of individuals.

'Lifting of the corporate veil' acts as a check on the doctrine of separation power which protects the shareholders from being liable to an extent above their investment.

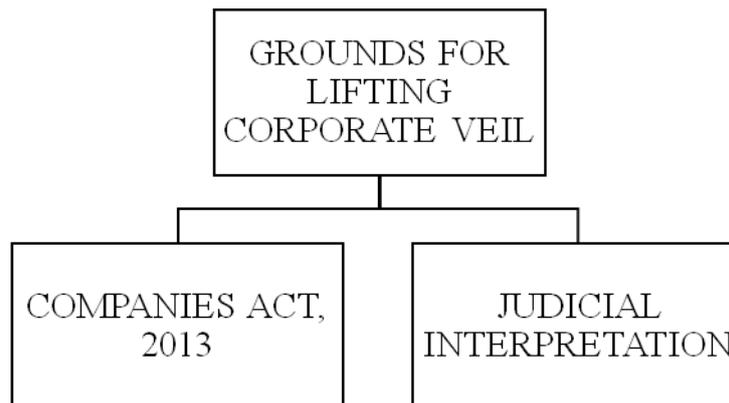


### GROUND FOR LIFTING OF THE VEIL (INDIAN LAW)

Following are the circumstances under which Indian Courts may lift or 'pierce' the corporate veil of a company:

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<sup>9</sup> Black's Law Dictionary 1168 (7th ed. 1999)



### STATUTORY PROVISIONS UNDER COMPANIES ACT, 2013

Some of the provisions in the Companies Act 2013 that provide for lifting of the corporate veil are mentioned below.

→ S.45: Reduction in membership

As per this section, if the number of members in a public company falls below 7 (or 2 in case of a private company) and the company continues with its business for more than 6 months with the reduced membership, the Court can lift the veil to impose liability on all members who knew about this.

→ S.147: Mis-description / Improper use of name

As per this section, if an officer of the corporate signs on a cheque, promissory note, bill of exchange, hundi, or any other instrument on behalf of the corporate such that he does not mention the name of the company properly or in the prescribed manner, the corporate veil can be lifted to hold that officer responsible in case of non-payment.

→ S.542: Liability in case of fraud while conducting business

As per this provision, if during the course of winding up of a company, it is found that any activity has been carried on with the intention to commit fraud against the creditors or any other purpose or for any other dishonest purpose, the persons behind this activity shall be personally liable for any or all debts without any limitations on their liability.

Other sections include S.239, 299, and S. 314 of the Companies Act 2013.

### JUDICIAL INTERPRETATION

There are various grounds that have been established by the judiciary where it chooses to ignore the corporate veil of the companies and directly deal with the members of the company.

Following are some of these grounds that have become well-established basis over the years to lift the veil:

#### 1. FRAUD

This is the most frequently applied ground for the doctrine of lifting of the corporate veil.

The landmark case under this ground is that of *Gilford Motor Co Ltd v Horne*<sup>10</sup> wherein an employee incorporated a company in his wife's name for the sole purpose of soliciting the customers of his employer which was against his employment contract. Therefore, the Court lifted the corporate veil and held the employee liable.

In another important case of *Jones v. Lipman*<sup>11</sup>, a man contracted to sell a piece of land but changed his mind last minute. Thereafter, to avoid an order of specific performance, he transferred the property to a company incorporated by him for the sole purpose of avoiding specific performance. The Court lifted the corporate veil and ordered specific performance from both the man and the company he incorporated.

Over the many years, three criteria have been determined on the basis of which it may be decided whether corporate veil can be lifted or not. These are as follows:

- 1) What are the motives of the persons committing fraud?
- 2) Is the character of the legal obligation breached by the person of significance?
- 3) Is the time period of incorporation of the company of significance?

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<sup>10</sup> *Gilford Motor Co Ltd v Horne* [1933] Ch. 935 (CA)

<sup>11</sup> *Jones v. Lipman* [1962] 1 WLR 832

2. AGENCY

A company does not by itself or automatically becomes the agent of its shareholders even in cases of a one-man company. This was established in *Solomon v. Solomon Co Ltd*.

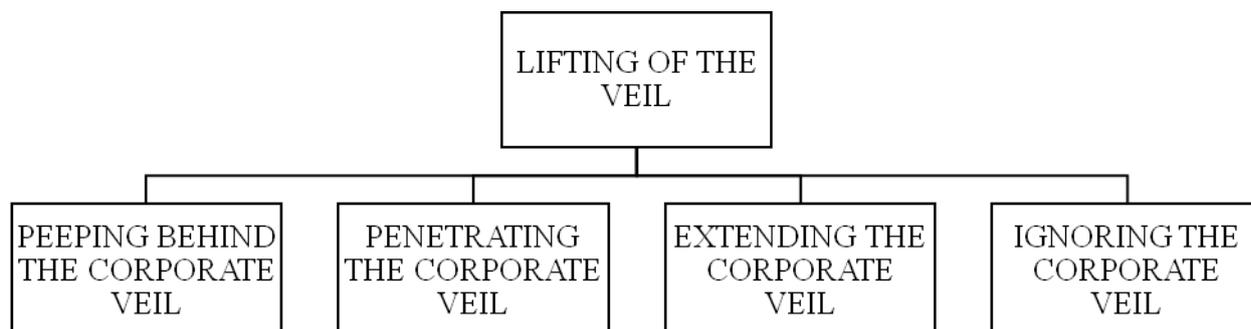
However, a company may possess the power to act as an agent for its parent company, any or all individual members only if it is authorized by them to do so. In such cases, the parent company or the individual members will be held to be bound by the acts of the company given it acted within the scope of its agency.

3. ENEMY CHARACTER

During the times of war, the Courts lifted the corporate veil whenever they came to know that behind the veil there is some association with an enemy state. Cases already discussed above such as the *Daimler Co Ltd v. Continental Tyre & Rubber Co* are instances of this.

VARIOUS APPROACHES TO THE CONCEPT OF THE VEIL

There are various approaches to lifting of the metaphorical ‘veil’ of a corporation. Different cases call for different approaches depending on the facts and circumstances of that particular situation. A particular matter may involve employing of more than one approaches at once. The four commonly employed approaches are discussed below:



1) PEEPING BEHIND THE CORPORATE VEIL

This approach is employed by the courts particularly when they are curious about the identity of the shareholders and the extent of their holding in the corporate. They may also require information regarding the controlling authority in the company. Once this information is received, the veil is drawn again i.e. the corporate regains its separate identity.

For instance, in the case of *Daimler company ltd. v Continental Tyre and Rubber Company*<sup>12</sup>, the courts were asked to determine whether an English company was required to pay the plaintiff company, which was an English registered company with its shareholders and Directors belonging to the enemy state (Germany). In this case, the Courts had to peep behind the corporate veil to determine if the plaintiffs were of enemy character.

2) PENETRATING THE CORPORATE VEIL

Courts may resort to penetrating the corporate veil if they wish to determine the shareholders with controlling authority so as to impose responsibility on them for the acts of the corporation.

In the case of *R v. London County Council*<sup>13</sup>, a cinematographer was refused a license on grounds that a majority of the controlling authority lay in the hands of German shareholders such that the transactions were of enemy character.

<sup>12</sup> *Daimler company ltd. v Continental Tyre and Rubber Company (Great Britain)*, [1916] 2 AC 307

<sup>13</sup> *R v London County Council, ex p London & Provincial Electric Theatres Ltd.* [1915] 2 KB 466.

3) EXTENDING THE CORPORATE VEIL

Sometimes, when a matter involves more than one corporate entity such that they have done a common activity, the Court may bring the various corporate entities under a single, extended corporate veil such that they are treated as one single entity.

This approach is most common where a parent company and its manifold subsidiaries are involved such that the parent company owns all of the shares of its subsidiaries. For instance, in *DHN Food Distributors Ltd. v London Borough of Tower Hamlets* wherein the plaintiff complained of disturbance caused by the expropriation of land by another company. In this case, the company and its two subsidiaries were brought under the ambit of an extended veil.

4) IGNORING THE CORPORATE VEIL

The most extreme approach to lifting of the veil, this is employed when the it is brought to the attention of the Court that a particular company was incorporated only for a dishonest and fraudulent purpose so as to achieve circumvention of laws. In most cases, there is some public wrong or crime that is committed by the corporate.

## REVERSE LIFTING OF THE CORPORATE VEIL

BASIC CONCEPT

‘Reverse lifting of the corporate veil’ essentially refers to a concept that is polar to the lifting of the corporate veil. Under this concept, a liability is imposed on a corporation for the acts or omissions of a member or shareholder of that corporation.

This doctrine first surfaced in the case of *Kingston Dry Dock Co. v. Lake Champlain Transportation Co*<sup>14</sup>. In this case, Kingston, repaired the ship belonging to the defendant’s subsidiary company while he was in an agreement with the defendant. When the defendant defaulted, Kingston attached the boat he repaired to fulfill the debt the defendant owed him. The judge for this case adopted a narrow view towards reverse lifting of the corporate veil and held that making a subsidiary liable for the actions of its parent company should only be done on rare occasions. This decision by Judge Hands remained the only authority on reverse lifting of the veil for the next 30 years<sup>15</sup>.

This doctrine then re-emerged in the case of *W.G. Platts, Inc. v. Platts*<sup>16</sup> wherein a divorced wife was permitted to receive assets of the company of her husband to satisfy her entitlement. The Court believed that a corporation was an ‘alter-ego’ of the person running it. This doctrine was further called in the landmark case of *Shamrock Oil & Gas v. Ethridge*<sup>17</sup>. Here, the creditor of a person was allowed to lift the veil when it was established that the person of who owed money had transferred all his wealth to a company incorporated for this purpose only.

Another important case law in regards to reverse lifting of the veil is *G.M. Leasing Corporation v. United States*<sup>18</sup>. In this case it was observed that the Courts were more likely to apply this doctrine if the reverse lifting was sought by the government While the individual

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<sup>14</sup> *Kingston Dry Dock Co. v. Lake Champlain Transportation Co*

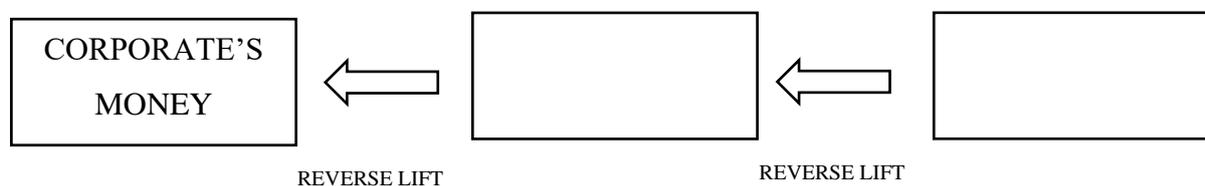
<sup>15</sup> Michael Richardson, THE HELTER SKELTER APPLICATION OF THE REVERSE PIERCING DOCTRINE, 79 U. Cin. L. Rev. (2011)

<sup>16</sup> *W.G. Platts, Inc. v. Platts*

<sup>17</sup> *Shamrock Oil & Gas v. Ethridge*

<sup>18</sup> *G.M. Leasing Corporation v. United States*

was not even a director, officer or an incorporator, just a mere equitable owner, reverse lifting was permitted.



### APPLICATION OF REVERSE LIFTING OF THE VEIL BY COURTS

When faced with the question regarding applicability of reverse lifting, the Courts have largely taken a decision on the basis of one of the three approaches that are discussed below.

#### STRICT ADHERENCE TO THE DOCTRINE OF SEPRATE LEGAL ENTITY

While employing this approach, the Courts hold the stance that there is no exception to the doctrine of separate legal entity. The fundamental theory behind this approach is that an individual of a corporation should not be allowed to raise or drop the veil as per his convenience. Therefore, cases decided by this approach do not involve application of reverse lifting of the veil.

A landmark judgement under this approach is the *Boggs v. Blue Diamond Coal Co*<sup>19</sup> case wherein a plaintiff filed a suit against a parent company against the subsidiary maintaining a coal mine with negligence and recklessness. The Court did not provide for reverse lifting of the veil and this was strongly criticised. The Court failed to consider that (i) the parent company owned total stock of the subsidiary company, (ii) the subsidiary company sold all the coal to the parent company and (iii) the parent company provided all the funds required by the subsidiary to meet its expenses. The Court also failed to consider that the most important fact i.e. the parent company had undertaken the primary responsibility to ensure safety at the subsidiary company's mine. However, this forms a typical example under this approach.

<sup>19</sup> *Boggs v. Blue Diamond Coal Co* 444 U.S. 836 (1979)

### TRADITIONAL LIFTING OF THE VEIL APPROACH

The decisions by the Courts under this approach are equally appreciated and criticised. This is considered as a step in the right direction. The Courts under this approach recognize the need for modern principles to deal with modern corporations. They do not think of reverse lifting of the veil as unfair or one-sided.

However, since there are no definite standards against which the court grants the reverse lifting or no definite factors on the basis of which a decision is made, this approach is characterized as unpredictable and random.

### EQUITABLE AND PUBLIC POLICY CONCERNS

Under this theory, the Courts refrain from absolutely denying the opportunity of reverse lifting of the veil. It is a more flexible approach that considers the applicability on its merits.

However, even this approach by courts is criticized for lacking definite standards so as to enable the corporations to sort their business from the very start.

## NEED FOR REVERSE LIFTING OF THE CORPORATE VEIL AND ITS RESOLUTION

If one were to compare the pros with the cons, it is the cons that outweigh as reverse lifting of the veil has caused injuries to innocent shareholders, other creditors or any other innocent stakeholders of a corporation. The doctrine as it exists today is highly problematic for the Courts as it involves a number of shareholders that runs in thousands. Even one of those shareholders is a gateway to a money hungry creditor to lift the corporate veil and extort money. This is bound to take a hit on the way any business conducts its commercial activities. There is a prejudice towards third parties involved.

While the above is true and agreed upon by multiple Courts, many believe that once all the parameters for lifting a corporate veil are met, the direction of lifting is irrelevant<sup>20</sup>. The main

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<sup>20</sup> Michael J. Gaertner, Reverse Piercing the Corporate Veil: Should Corporation Owners Have It Both Ways?, 30 Wm. & Mary L. Rev. 667 (1989)

purpose of identifying fraudulent activities and achieving equity are either ways and therefore, reverse lifting is as important as forward lifting of the veil

There does not exist any final statement by any Court condoning reverse lifting of the veil as an employable doctrine. It is a theory still growing. Reverse lifting should only be granted when all other remedies have been exhausted. It is believed that by the time the Courts fully develop a definite test to determine the applicability of reverse lifting of the veil, we must focus on the presence of alternative remedies that uphold the separate legal personality of a corporation.

To resolve all the concerns associated with reverse lifting of the veil, a ‘hybrid approach’ is being proposed. According to this approach, anyone who claims application of this doctrine will be required to establish a certain degree of identity between the corporation and its owner. An illustration for the same would be as follows.

Illustration: There exists a person X who runs a stationery store. He incorporates a private company XX Co Ltd that deals exclusively in books. The Board of Directors consist of a sibling of his and a relative of his. The shares are distributed between them. A creditor of X claims application of doctrine of reverse lifting of the corporate veil so as to recover money from the company when X was declared as insolvent. To establish a degree of identity, the following factors are brought forward:

- X used the funds of the company for personal expenses and usage such as buying a car, an apartment, etc.
- The two directors did not attend any meetings and did not receive any dividend as shareholders.

XX Co Ltd can be identified as an ‘alter ego’ of the X. Reverse lifting of corporate veil may be awarded if one adopted the hybrid approach.

## CONCLUSION

In the words of Benjamin Cardozo, *“Metaphors in law are to be narrowly watched, for starting as devices to liberate thought; they end often by enslaving it.”*. These words accurately represent the use of phrase ‘corporate veil’ and the deliberations regarding it.

The metaphorical veil between a corporate and its shareholders has had its own share of debates and discussions over many years. While lifting of the corporate veil has received proper doctrinism, the ‘reverse’ lifting of the corporate veil is often seen as an unfit doctrine with much little scope. From being applicable in the rarest of rare cases to now being rejected by courts, there needs to be a fresh approach to the doctrine if it is to survive.

The ‘Hybrid Approach’ that is being proposed by various legal scholars is being regarded as an integrative approach and proposes to offer relief to all those innocent parties that were being roped in without any remedy to them. While the Indian legal system has had fewer opportunities to encounter the concept of ‘reverse’ lifting of the veil, the proposed ‘Hybrid approach’ can play a very big role in moulding the fairly recent Indian corporate law. Till then, it must be left to the Courts to use the doctrine in circumstances which allow it.