

# Lifting the veil of incorporation



Critically evaluate, with reference to relevant case law and statute, how far this statement accurately reflects the current law relating to lifting the veil of incorporation.

## **Introduction**

Salomon v Salomon[1]involved the principle of separate corporate personality. This states that as a general rule a limited company's shareholders are not liable for the company's debts beyond the nominal value of their shares[2]. However, in certain situations courts have ignored this principle[3]. Courts have done this under statute, during wartime, where there is an agency or trust arrangement, where the company was a sham, or when dealing with groups of companies. Recent decisions such as Adams v Cape Industries plc[4]andPrest v Petrodel Resources Ltd[5]have reaffirmed the principle in Salomon. However, courts have still been willing to ignore the Salomon principle, most notably in Chandler v Cape plc[6].

## **Salomon v Salomon**

Salomon v Salomon is an important case, as it established the principle that a limited company has a separate legal personality from its members. This is enshrined in s. 74(2) Insolvency Act 1986, which states that in a company limited by shares, no member (or shareholder) is liable for any of the company's debts other than the amount (if any) on any unpaid shares. This is a great incentive for investors, who know that even if a limited company in which they own shares, owes millions of pounds in debts, their own personal assets are safe[7].

In Salomon a sole trader incorporated his business into a limited company. When the company failed, the liquidators argued that Salomon and the  
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company were effectively one and the same. However, the House of Lords said that the company was a legal entity distinct from its members.

Therefore, Salomon himself was not liable for the company's debts. This separation between members and company is called the 'corporate veil'.

Corporate personality means that a company can sue and be sued in its own right and be a party to contracts, and exist after the death of its shareholders[8]. This was recognised by the House of Lords in *VTB Capital v Nutritek Intl Corpn*[9] where Lord Neuberger said: 'A company should be treated as being a person by the law in the same way as a human being.' Therefore, the Salomon principle remains an important part of corporate law today.

### **Lifting the veil**

However, there are several exceptions to this principle. In these cases courts 'lift the corporate veil' to make members liable for the actions of the company[10]. This undermines the notion that Salomon occupies the centre stage in corporate law today.

### **Statute**

s. 213 Insolvency Act 1986 states that if, while winding up a company, the company's business is carried on with intent to defraud the company's creditors, a court may order any person knowingly carrying on the business to contribute to the company's assets. This goes against Salomon, as it holds the company's members responsible for its debts. However, it requires evidence of dishonesty[11]. This is difficult to prove.

s. 214 Insolvency Act 1986 states that if, while winding up a company, a director ought to have seen that there was no reasonable prospect of avoiding insolvency but continued to carry on business, then a court may hold them liable. There is no need for any dishonesty. However, this only applies to ‘directors’ and not shareholders. Even so, the Companies Act 2006 states that a ‘director’ includes a ‘shadow director’, which includes anyone other than a professional advisor in accordance with whose directions or instructions the directors of the company are accustomed to act[12]. This could include a parent company if they have direct control over one of their subsidiary companies. Therefore, in a limited way, this restricts the Salomon principle where there is wrongdoing involving the company.

### **War**

Courts may also ignore the corporate veil during wartime. In *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd*[13] a company was incorporated in England but the vast majority of its members were German. The House of Lords stated that whether a company was an enemy in wartime depended upon those who were in control of the company. This goes against the principle of separate corporate personality and weakens the idea that Salomon is always to be followed.

### **Sham**

Courts have also ignored the corporate veil where a company is a sham designed to commit fraud or avoid an existing contractual obligation. For instance, in *Gilford Motor Co v Horne*[14] the defendant was a former director of a company who signed an agreement that he would not solicit his former employer’s customers. Instead, he and his wife incorporated another

company which he used to breach the agreement. The court held that the second company was simply ‘ a cloak, or a sham’ and held the defendant liable.

However, courts will not lift the veil if the company is set up to avoid future liabilities[15]. Some commentators also argue that these cases do not involve lifting the corporate veil at all. Mayson, French and Ryan state that even if the agency used to commit the fraud or evade the obligation had been another person rather than a company, the result would have been the same[16]. The court in *Gilford* recognised this by making orders against both the defendant and the company. If this is correct, these cases do not necessarily go against *Salomon v Salomon*.

### **Agency**

Courts have also ignored the veil where they have found an agency relationship existed. In *Re FG Films Ltd*[17] a company sought a declaration that it had made a British film for financial reasons. The court held that in fact the UK company was only the agent for an American company which owned the vast majority of its shares. The UK company also had no place of business and existed only so that the film could be called ‘ British’. The court, therefore, lifted the veil.

However, this has been criticised by commentators who note that, if this is correct, a court could infer an agency relationship merely from the act of being a shareholder[18]. Therefore, this High Court case seems to be wrongly decided, and the House of Lords decision in *Salomon* remains the higher authority.

**Trusts**

Courts have also ignored the corporate veil where they have found a trust relationship exists. In *Trebanog Working Men's Club and InSTITUTE Ltd v MacDonald*[19] an incorporated club was charged with selling liquor without a licence. The court held that as the members owned the liquor between themselves, there was no actual 'sale', and the club was simply a trustee of the liquor for its members. However, this contradicts an earlier case where the opposite decision was reached[20], and commentators note that this argument is 'at best tenuous'[21]. Therefore, this probably does not undermine *Salomon*.

**Groups**

Case law is more contradictory as to whether groups of companies will be treated as another exception to *Salomon*. In a group, the parent company can own a number of subsidiary companies and still have separate corporate personality from them[22]. Traditionally, courts have held that this is a legitimate use of the corporate form, and that each company in a group is a separate legal entity[23]. However, in *DHN Food Distributors Ltd v Tower Hamlets LBC*[24], Denning MR in the Court of Appeal held that a parent company and its subsidiaries were a 'single economic entity' as the subsidiaries were 'bound hand and foot to the parent company', so the group was the same as a partnership. This undermines the *Salomon* principle.

In *Woolfsion v Strathclyde Regional Council*[25], the House of Lords disapproved of Denning's comments and said that the corporate veil would be upheld unless the company was a façade. The *DHN* case approach has

become less popular since then[26]. Commentators also note that the DHN case is self-contradictory[27]. Denning refers to the subsidiaries as being ‘bound hand and foot’ to the parent company, which implies the parent has control, but he also says they are ‘partners’, which implies they have equal power. Therefore, it seems unlikely that DHN will be followed in future, especially given the Court of Appeal’s later decision in *Adams v Cape Industries plc*.

### **Cases that support the Salomon principle**

In *Adams v Cape* an English company was sued for the actions of one of its subsidiaries abroad. The subsidiary had caused injury to its workers through asbestos exposure. The Court of Appeal held that the parent company was not liable. The court held that the subsidiary was not a façade or sham as the group had been structured that way only to minimize future liabilities. The court also rejected the argument that the subsidiary was an agent for the parent company, as the subsidiary was carrying on its own business. Finally, the court held that there was no general principle that all the companies in a group should always be treated as a single economic entity.

This reaffirms the Salomon principle. In fact the court in *Adams* stated that DHN could be explained as a matter of statutory interpretation of the regulations regarding compulsory purchases at the time, and hence it did not actually involve lifting the corporate veil. Dignam says: ‘Gone are the wild and crazy days when the Court of Appeal would lift the veil to achieve justice irrespective of the legal efficacy of the corporate structure’[28]. Therefore, *Adams* restores the primacy of *Salomon v Salomon*.

This is supported by the recent Supreme Court decision in *Prest v Petrodel Resources Ltd*, where a divorced wife claimed shares in houses owned by companies in which her ex-husband was the controlling shareholder. She asked the court to lift the corporate veil and treat her ex-husband and the companies as being effectively the same. However, the court held that the veil could not be lifted without evidence of impropriety. The setting up of the companies had nothing to do with the marriage breakdown. Therefore, the court refused to lift the veil.

Lord Sumption stated that the veil could only be lifted if there was a legal right against the controller of a company and the company's separate legal personality frustrated that right<sup>[29]</sup>. Also, it must be necessary for the court to lift the veil on public policy grounds. Critics have noted that it is very unlikely that these requirements will be met<sup>[30]</sup>. Also, although Lord Sumption's comments were obiter, they have been cited with approval in other cases and are therefore likely to be authoritative<sup>[31]</sup>. However, Baroness Hale in the same case did not agree, saying that she believed there were more cases where the veil could be lifted<sup>[32]</sup>. Therefore, the judgments are contradictory.

In the end, the court decided that the properties were held on resulting trust for the ex-husband and could be claimed by his ex-wife. This arguably achieves the same thing as if the court had lifted the veil. Consequently, all that can be said is that the case does not rule out ignoring *Salomon* in cases involving groups of companies.



**A new attitude?**

Another exception to Salomon involves tortious liability. In *Chandler v Cape* the claimant had also contracted an asbestos-related disease while working for a subsidiary of the parent company. This time the Court of Appeal held the parent liable in the tort of negligence. The court held that the parent would be liable if the parent and subsidiary were in the same business, the parent had superior knowledge of health and safety in that industry, the parent ought to have known the subsidiary's system of work was unsafe, and the parent ought to have foreseen that the subsidiary would rely on the parent's superior knowledge.

This undermines the Salomon principle. However, critics note that Cape had an unusual business organisation where it was deeply involved in the day-to-day supervision of the subsidiary's health and safety policy. Therefore, the case may turn out to be 'Cape specific'[33]. For instance, in a later case with similar facts but concerning a different company, the Court of Appeal refused to hold the parent company liable[34].

In *Chandler Lady Hale* also emphatically rejected that this was a case of corporate veil lifting, saying that the parent had instead assumed a direct duty of care for the employee. In view of this, some critics state that the case may not be setting any useful precedent[35]. However, others view this clearly as veil lifting, regardless of how the court justified this[36].

These commentators believe that this suggests that the Court of Appeal is now more willing to lift the veil where there is a group of companies and it is in the interests of justice[37]. However, this was rejected in *Adams v Cape*.

Even so, in *Conway v Ratiu*[38]the court again said there was a ‘ powerful argument’ for lifting the veil where it ‘ accords with common sense and justice’. Unfortunately, this case is per incuriam as it did not refer to *Adams v Cape* and is probably wrong. Even so, in *Lubbe v Cape Plc*[39]the House of Lords were ready to lift the veil in the interests of justice in facts similar to *Adams v Cape*, as the foreign jurisdiction where the tort occurred was not an appropriate place to try the matter. Therefore, there is authority for lifting the veil when justice demands it.

In following *Lubbe*, the court in *Chandler v Cape* achieved justice, as the victims would otherwise have been denied a remedy. This is important where the subsidiary no longer exists or has any assets[40]or with asbestos claims where the disease may not show up for many years[41]. The Supreme Court in *Prest v Petrodel* was also concerned with achieving justice for the claimant[42], and in the *VTB* case Lord Neuberger said: ‘ it may be right for the law to permit the veil to be pierced in certain circumstances in order to defeat injustice’[43].

Therefore, it seems that the courts are willing to disregard the Salomon principle in some cases involving personal injury or groups of companies. This seems fair, as limited liability encourages subsidiary companies to take risks, knowing that the shareholders of the parent company in effect get double protection from creditors should anything go wrong[44]. To hold otherwise would have been to deny justice to the claimant in *Chandler v Cape*.

## **Conclusion**

The principle of separate corporate personality and the corporate veil recognised in *Salomon v Salomon* remains central to corporate law despite several challenges. However, there are certain exceptions when the veil will be lifted. Most notably these include under statute, during wartime, and where the company is a sham. It is less likely to be lifted where it is argued that an agency or trust relationship existed between the company and its controller. Where groups are involved, *Salomon* remains the starting point. However, courts have been more willing to lift the veil recently, especially where personal injury is involved or justice demands it, even if they do not say so explicitly. This seems fair, as otherwise shareholders enjoy double protection.

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### Footnotes

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