Chapter 4 Lifting the veil of incorporation

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Introduction

As we observed in Chapter 3 the application of the Salomon principle has mostly (remember Mr Macaura) beneficial effects for shareholders. The price of this benefit is often paid by the company’s creditors. In most situations this is as is intended by the Companies Acts. Sometimes, however, the legislature and the courts have intervened where the Salomon principle had the potential to be abused or has unjust consequences. This is known as ‘lifting the veil of incorporation’. That is, the courts or the legislature have decided that in certain circumstances the company will not be treated as a separate legal entity. In this chapter we examine the situations where the legislature and the courts ‘lift the veil’.

Learning outcomes

By the end of this chapter and the relevant readings, you should be able to:

- describe the situations where legislation will allow the veil of incorporation to be lifted
- explain the main categories of veil lifting applied by the courts.

Essential reading

- Dignam and Lowry, Chapter 3: ‘Lifting the veil’.
- Davies, Chapter 8: ‘Limited liability and lifting the veil at common law’ and Chapter 9: ‘Statutory exceptions to limited liability’.

Cases

- Gilford Motor Company Ltd v Horne [1933] Ch 935
- Jones v Lipman [1962] 1 WLR 832
- D.H.N. Ltd v Tower Hamlets [1976] 1 WLR 852
- Woolfson v Strathclyde RC [1978] SLT 159
- Re a Company [1985] 1 BCC 99421
- Adams v Cape Industries plc [1990] 2 WLR 657
- Creasey v Breachwood Motors Ltd [1992] BCC 638
- Ord v Belhaven Pubs Ltd [1998] 2 BCLC 447
- Williams v Natural Life Health Foods Ltd [1998] 2 All ER 577

Additional cases

- Re Todd Ltd [1990] BCLC 454
- Re Patrick & Lyon Ltd [1993] Ch 786
- Re Produce Marketing Consortium Ltd (No 2) [1989] 5 BCC 569
- Trustor AB v Smallbone [2002] BCC 795
- Noel v Poland [2002] Lloyd’s Rep IR 30
- Daido Asia Japan Co Ltd v Rothen [2002] BCC 589
- Standard Chartered Bank v Pakistan National Shipping Corp (No 2) [2003] 1 AC 959
- MCA Records Inc v Charly Records Ltd (No 5) [2003] 1 BCLC 93
4.1 Legislative intervention

As corporate affairs became more complex and group structures emerged (that is, where a parent company organises its business through a number of subsidiary companies in which it is usually the sole shareholder) the Companies Acts began to recognise that treating each company in a group as separate was misleading. Over time a number of provisions were introduced to recognise this fact. For example:

- s.399 CA 2006 provides that parent companies have a duty to produce group accounts
- s.409 CA 2006 also requires the parent to provide details of the shares it holds in the subsidiaries and the subsidiaries’ names and country of activity.

However, it was the possibility of using the corporate form to commit fraud that prompted the introduction of a number of civil and criminal provisions. These provisions operate to negate the effect of corporate personality and limited liability in:

- s.993 CA 2006 which provides a not much used criminal offence of fraudulent trading
- ss.213–215 Insolvency Act 1986 which contain the most important statutory veil lifting provisions.

4.1.1 Insolvency Act, s.213

Section 213 of the Insolvency Act 1986 was designed to deal with situations where the corporate form was used as a vehicle for fraud. It is known as the ‘fraudulent trading’ provision. If, in the course of the winding up of a company, it appears to the court that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, anyone involved in the carrying out of the business can be called upon to contribute to the debts of the company. This is most likely to be shareholders or directors but can also be employees and creditors. In *Re Todd Ltd* [1990] BCLC 454, for example, a director was found liable to contribute over £70,000 to the debts of the company because of his activities. There is also the possibility that criminal liability could follow, with a term of imprisonment as the ultimate penalty (s.993 CA 2006). While the criminal penalty was intended to act as a strong deterrent to fraudulent behaviour, it proved to have the unfortunate effect of neutralising the effectiveness of s.213 as the courts set a very high standard of proof for ‘intent to defraud’ because of the possibility of a criminal charge also arising. In *Re Patrick & Lyon Ltd* [1933] Ch 786, this involved proving ‘actual dishonesty, involving, according to current notions of fair trading among commercial men, real moral blame’. This standard proved very difficult to obtain in practice and a new provision was introduced in s.214 of the Insolvency Act 1986 which covered the lesser offence of ‘wrongful trading’.

4.1.2 Insolvency Act, s.214

Wrongful trading does not require proving an intent to defraud. Rather it simply requires that a director, at some time before the commencement of the winding up of the company, knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, but continued to trade. The section operates on the basis that at some time before the company entered insolvent liquidation there will have been a point where the directors knew it was hopeless and the company could not trade out of the situation. The reasonable director would not at this point continue to trade. If he does continue to trade he risks having to contribute to the debts of the company under s.214.

In *Re Produce Marketing Consortium Ltd (No 2)* (1989) 5 BCC 569 over a period of seven years the company slowly drifted into insolvency. The two directors involved did nothing wrong except that they did not put the company into liquidation after the point of no return became apparent. They were therefore liable under s.214 to contribute £75,000 to the debts of the company.
Sections 213 and 214 differ in the way they affect the *Salomon* principle. Section 213 applies to anyone involved in the carrying on of the business and therefore directly qualifies the limitation of liability of members. Section 214 does not directly affect the liability of members as it is aimed specifically at directors. In small companies, directors are usually also the members of the company and so their limitation of liability is indirectly affected. Parent companies may also have their limited liability affected if they have acted as a shadow director. (A shadow director being anyone other than a professional advisor from whom the directors of the company are accustomed to take instructions or directions – see Chapter 14.)

**Activity 4.1**

a Explain the difference between ss.213 and 214 of the Insolvency Act 1986.
b Why was s.213 relatively unsuccessful?
c What is s.214 designed to achieve?

No feedback provided.

**Summary**

The legislature has always been concerned to minimise the extent to which the *Salomon* principle could be used as an instrument of fraud. As a result it introduced the offence of fraudulent trading now contained in s.213 of the Insolvency Act 1986.

The requirement to prove ‘intent to defraud’ became too difficult in practice because of the possibility of a criminal offence arising and so the lesser offence of ‘wrongful trading’ was introduced in order to provide a remedy where directors had behaved negligently rather than fraudulently. Thus if a director continued to trade in circumstances where a reasonable director would have stopped, the director concerned will be liable to contribute to the company’s debts under s.214.
4.2 Judicial veil lifting

Veil lifting situations often present the judiciary with difficult choices as to where the loss should lie. As we observed with the Salomon, Lee and Macaura cases, the consequences of treating the company as a separate legal entity or not can be extreme. Over time the judiciary have swung from strictly applying the Salomon principle in these difficult situations to taking a more interventionist approach to try to achieve justice in a particular situation. The following cases should give some flavour of the types of situations that have arisen and the approach taken by the judiciary at the time.

In Gilford Motor Company Ltd v Horne [1933] Ch 935 a former employee who was bound by a covenant not to solicit customers from his former employers set up a company to do so. He argued that while he was bound by the covenant the company was not. The court found that the company was merely a front for Mr Horne and issued an injunction against him.

In Jones v Lipman [1962] 1 WLR 832 Mr Lipman had entered into a contract with Mr Jones for the sale of land. Mr Lipman then changed his mind and did not want to complete the sale. He formed a company in order to avoid the transaction and conveyed the land to it instead. He then claimed he no longer owned the land and could not comply with the contract. The judge found the company was but a façade or front for Mr Lipman and granted an order for specific performance.

By the 1960s the increasingly sophisticated use of group structures was beginning to cause the courts some difficulty with the strict application of the Salomon principle. Take, for example, a situation where Z Ltd (the parent or holding company) owns all the issued share capital in three other companies – A Ltd, B Ltd and C Ltd. These companies are known as wholly owned subsidiaries (s.1159(2) CA 2006). Z Ltd controls all three subsidiaries. In economic reality there is just one business but it is organised through four separate legal personalities. In effect this structure allows the advantages of limited liability to be availed of by the legal personality of the parent company. As a result the parent could choose to conduct its more risky or liability-prone activities through A Ltd. The strict application of the Salomon principle would mean that if things go wrong the assets of Z Ltd, as a shareholder of A Ltd with limited liability, in theory cannot be touched.

In DHN Ltd v Tower Hamlets [1976] 1 WLR 852 Lord Denning argued that a group of companies was in reality a single economic entity and should be treated as one. Two years later the House of Lords in Woolfson v Strathclyde RC [1978] SLT 159 specifically disapproved of Denning’s views on group structures in finding that the veil of incorporation would be upheld unless it was a façade. The case of Adams v Cape Industries plc [1990] 2 WLR 657 represents a significant move by the senior judiciary towards introducing more certainty into the interpretation of Salomon issues.

4.2.1 Adams v Cape Industries plc (1990)

Adams is a complex case but, broadly, the following occurred. Until 1979, Cape, an English company, mined and marketed asbestos. Its worldwide marketing subsidiary was another English company, named Capasco. Cape also had a US marketing subsidiary incorporated in Illinois, named NAAC. In 1974 in Texas, some 462 people sued Cape, Capasco, NAAC and others for personal injuries arising from the installation of asbestos in a factory. Cape protested at the time that the Texas court had no jurisdiction over it but in the end it settled the action. In 1978, NAAC was closed down by Cape and other subsidiaries were formed with the express purpose of reorganising the business in the US to minimise Cape’s presence there, in respect of taxation and other liabilities. Between 1978 and 1979, a further 206 similar actions were commenced and default judgments were entered against Cape and Capasco (who again denied they were subject to the jurisdiction of the court but this time did not settle). In 1979 Cape sold its asbestos mining and marketing business and therefore had no assets in the US. Adams sought the enforcement of the US default judgment in England. The key issue was whether Cape was present within the US jurisdiction through its subsidiaries or had somehow submitted to the US jurisdiction. According to the Court of Appeal that could only be the case if it lifted the veil of incorporation, either treating the Cape group as a single entity, or finding the subsidiaries were a mere façade or were agents for Cape.
The court found that in cases where the courts had in the past treated a group as a ‘single economic unit’, thus disregarding the legal separateness of each company in the group, the court was involved in interpreting a statute or document (see below). This exception to maintaining corporate personality is qualified by the fact that there has to first be some lack of clarity about a statute or document which would allow the court to treat a group as a single entity. The court concluded that:

save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of Salomon v Salomon & Co Ltd [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.

The Court of Appeal recognised the ‘mere façade concealing the true facts’ as being a well-established exception to the Salomon principle. The case of Jones v Lipman (1962) above is the classic example. There Mr Lipman’s sole motive in creating the company was to avoid the transaction. In determining whether the company is a mere façade the motives of those behind the alleged façade may be relevant. The Court of Appeal looked at the motives of Cape in structuring its US business through its various subsidiaries. It found that although Cape’s motive was to try to minimise its presence in the US for tax and other liabilities (and that that might make the company morally culpable) there was nothing legally wrong with this.

The court then finally considered the ‘agency’ argument. This was a straightforward application of agency principle. If the subsidiary was Cape’s agent and acting within its actual or apparent authority, then the actions of the subsidiary would bind the parent. The court found that the subsidiaries were independent businesses free from the day-to-day control of Cape and with no general power to bind the parent. Therefore Cape could not be present in the US through its subsidiary agent.

Adams therefore narrows the situations where the veil of incorporation is in effect lifted to three situations.

- Where the court is interpreting a statute or document (thus once fairness is rejected as the basis of intervention only a lack of clarity in the statute or document will allow intervention).
- Where the company is a mere façade.
- Where the subsidiary is an agent of the company.

While there have been some notable departures from the Court of Appeal’s view in Adams (see Creasey v Breachwood Motors Ltd [1992] BCC 638, overruled by Ord v Belhaven Pubs Ltd [1998] 2 BCLC 447), the Court of Appeal’s interpretation in Adams of when veil lifting can occur has dominated judicial thinking up until very recently. There are now signs the courts seem to be relaxing the strict approach taken in Adams (see Ratiu v Conway (2006) 1 All ER 571 and Samengo-Turner v J&H Marsh & McLennan (Services) Ltd (2007) 2 All ER (Comm) 813).

Activity 4.2

Read Dignam and Lowry, 3.10–3.32 then write a short answer considering the following statement.

‘The Court of Appeal’s decision in Adams takes an overly cautious approach to veil lifting which does little to serve the interests of justice.’
4.3 Veil lifting and tort

A finding of tortious liability against a shareholder (usually also a director) for activities carried out through the medium of a company has the possibility of negating the Salomon principle. The courts have increasingly been faced with this possibility. The leading case on the issue is Williams v Natural Life Health Foods Ltd [1998] 2 All ER 577. There the House of Lords emphasised the Salomon principle in the context of a negligent misstatement claim. The managing director of Natural Life Health Foods Ltd (NLHF) was also its majority shareholder. The company’s business was selling franchises to run retail health food shops. One such franchise had been sold to the claimant on the basis of a brochure which included detailed financial projections. The managing director had provided much of the information for the brochure. The claimant had not dealt with the managing director but only with an employee of NLHF. The claimant entered into a franchise agreement with NLHF but the franchised shop ceased trading after losing a substantial amount of money. He subsequently brought an action against NLHF for losses suffered as a result of negligent information contained in the brochure. NLHF subsequently ceased to trade and was dissolved. The claimant then continued the action against the managing director and majority shareholder alone, alleging he had assumed a personal responsibility towards the claimant.

The House of Lords seemed particularly aware that the effect of this claim was to try to nullify the protection offered by limited liability. In its judgment the House of Lords considered that a director or employee of a company could only be personally liable for negligent misstatement if there was reasonable reliance by the claimant on an assumption of personal responsibility by the director so as to create a special relationship between them. There was no evidence in the present case that there had been any personal dealings which could have conveyed to the claimant that the managing director was prepared to assume personal liability for the franchise agreement (see also Noel v Poland [2002] Lloyd’s Rep. IR 30).

Other recent cases suggest that if the tort is deceit rather than negligence the courts will more readily allow personal liability to flow to a director or employee. (See Daido Asia Japan Co Ltd v Rothen [2002] BCC 589 and Standard Chartered Bank v Pakistan National Shipping Corp (No.2) [2003] 1 AC 959.)

However, directors’ liability in tort has proved to be less than settled. In MCA Records Inc v Charly Records Ltd (No 5) [2003] 1 BCLC 93 a director had authorised a number of infringing acts under the Copyright Designs and Patent Act 1988. The Court of Appeal in a very detailed consideration of the issue of directors’ liability in tort, including the Williams case, took a more relaxed approach to the possibility of liability. The court concluded:

there is no reason why a person who happens to be a director or controlling shareholder of a company should not be liable with the company as a joint tortfeasor if he is not exercising control through the constitutional organs of the company and the circumstances are such that he would be so liable if he were not a director or controlling shareholder.

The court then went on to find the director liable as a joint tortfeasor. (See also Koninklijke Philips Electronics NV v Princo Digital Disc GmbH [2004] 2 BCLC 50, where a company director was also held personally liable.)

Activity 4.3

Read Dignam and Lowry, 3.33-3.51 and consider whether involuntary creditors are adequately protected by the Adams decision.

Summary

It is important that you get a solid understanding of the issues facing the judiciary in this area. In essence the judiciary are being asked to decide who loses out when a business ends. In normal commercial situations this will be as the Companies Act intends – therefore the burden falls on the creditors. However if there is a suggestion that the company has been used for fraud or fraud-like behaviour (e.g. Jones v Lipman) the courts may lift the veil. At various times, however, the Salomon principle was only a starting point and the courts would lift the veil in a number of situations if the interests of justice required them to do so. This led to great uncertainty which has been redressed by the restrictive case of Adams.
Useful Further Reading


Sample Examination Questions

Question 1 John and Amanda are brother and sister and have been running the family business Rix Ltd for 10 years. They both sit on the board of directors of Rix Ltd and each holds 30 per cent of the shares in the company. The remaining shares are held equally by their father, Jim, and uncle, Tom. Jim and Tom used to run the company but have retired now. They still have seats on the board of directors. For the first five years after the retirement of Jim and Tom the company made an annual profit of approximately £100,000. After that the profits declined for three years and in the last two years the company has made losses of £50,000 and £100,000. John and Amanda have grave concerns about the future of the business but, at a board meeting to discuss ceasing trading, Jim and Tom insist that things will get better. The board resolves to continue trading.

Consider the implications for the board members of this decision.

Advice on answering these questions

Question 1 It appears that there is no suggestion of fraud here; rather it fits more with the case law on the application of s.214 IA 1986.

Apply s.214 to the facts of this question.

Does the board meeting represent the necessary ‘point of no return’?

Consider the possible voting at the meeting. If it was unanimous, there is no problem and the wrongful trading provisions apply to them all. However, boards vote by simple majority and so the possibility remains that one of the directors could have dissented. What would be that director’s position under s.214 if he or she wished to cease trading but the rest of the board voted to continue? If that director continues to carry out their role after the vote is he or she equally liable under s.214?

Question 2 Dick and his wife Bunny are owed £25,000 by Bio Ltd. Bio Ltd has refused to pay the money owed and Dick and Bunny have initiated a court action to recover the moneys owed to them. Bounce Ltd is the parent company of Bio Ltd and has recently been advised by its accountant that it could reduce its tax liability for the year 2008-2009 by removing all the assets from Bio Ltd and closing it down. Bounce Ltd has decided to follow that advice.

Discuss the implications of this decision for Dick and Bunny.

Advice on answering these questions

Question 2 This is a relatively straightforward question similar on its facts to the Ord and Creasey cases.

Ord follows Adams strictly and finds that a group reorganisation to minimise financial liability is allowable and will not engage a veil lifting exercise.

Creasey is a rogue case but it is worth applying here as an alternative, in which case Dick and Bunny might be able to recover from the parent company. However, you should note the more recent case law such as Ratiu v Conway (2006) 1 All ER 571 which seems to be moving away from the narrow approach in Adams.
Reflect and review

Look through the points listed below.

Are you ready to move on to the next chapter?

**Ready to move on** = I am satisfied that I have sufficient understanding of the principles outlined in this chapter to enable me to go on to the next chapter.

**Need to revise first** = There are one or two areas I am unsure about and need to revise before I go on to the next chapter.

**Need to study again** = I found many or all of the principles outlined in this chapter very difficult and need to go over them again before I move on.

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**If you ticked ‘need to revise first’, which sections of the chapter are you going to revise?**

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