Page 744 - 756 **DOI:** https://doij.org/10.10000/IJLMH.118558

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 7 | Issue 6

2024

Corporate Veil Theory: A Complete Analysis

SOMITRA VARDHAN DUBEY[1]

ABSTRACT

The company's own legal identity is the main benefit of incorporation, from which all other benefits stem. However, the legal person's activities are always carried out for their personal gain and by a small group of individuals. "While, by fiction of law, a corporation is a distinct entity, in actuality it is an association of individuals who are in fact the beneficial owners of all the corporate property," the final decision states, indicating that some individuals are the true beneficiaries of the corporate advantages.

The concept of a unique legal entity is not infallible; under certain conditions, the curtain may be raised, and this concept has emerged to address a number of issues with company law.

In actuality, the cornerstone of corporate entity theory serves as the framework for all business law. There are numerous instances where courts have effectively lifted the corporate veil.

***Keywords**: Company law, Corporate veil, theory, Salomon.*

I. INTRODUCTION

The doctrine of lifting the corporate veil is a well-established legal principle that enables courts to disregard the separate legal personality of a company and hold its shareholders or directors personally liable for the company's actions. This doctrine is typically invoked in cases where the corporate form is being misused for fraudulent or illegal purposes, such as money laundering, tax evasion, or other white-collar crimes. However, the Indian judiciary has often struggled to distinguish between two distinct scenarios: identifying the individuals behind the company (peeping behind the veil) and holding them personally liable (penetrating the veil). This confusion has led to potential injustices against innocent parties.

II. THE CONCEPT OF SEPARATE LEGAL PERSONALITY

One of the main tenets of company law is the idea of independent legal personality, which maintains that a business is a legal entity apart from its directors and stockholders. This implies that a business can engage in transactions, possess assets, and file or defend legal actions under its own name without the personal liability of its directors or shareholders. However, this

[1] Author is a student at Dharmashastra National Law University Jabalpur, India.

principle is not absolute, and the doctrine of lifting the corporate veil provides an exception to this rule.

(A) Peeping Behind the Veil vs. Penetrating the Veil

There are two distinct scenarios where the doctrine of lifting the corporate veil is applied:

1. **Peeping Behind the Veil**: This involves looking behind the corporate structure to identify the individuals who are actually controlling the company. In this scenario, the court is trying to determine who is pulling the strings and making decisions on behalf of the company. This may involve examining the company's ownership structure, management hierarchy, and decision-making processes to identify the individuals who are truly in control.
2. **Penetrating the Veil**: This involves holding those individuals personally liable for the company's actions, even if they have not personally committed any wrongdoing. In this scenario, the court is holding the individuals responsible for the company's actions, rather than just the company itself. This can entail making directors or shareholders personally liable for any debts, losses, or other commitments made by the business.

(B) The Indian Judiciary's Approach

The Indian judiciary has often blurred the lines between these two scenarios, leading to inconsistent and sometimes incorrect applications of the doctrine. In some cases, courts have lifted the corporate veil without properly establishing that the individuals behind the company were aware of or involved in the company's wrongdoing. In other cases, courts have failed to lift the veil even when there was clear evidence of fraudulent or illegal activities.

(C) Factors to Consider

To prevent future misapplications of the doctrine, courts should carefully consider the following factors:

1. **Nature of Company's Activities**[2]: The corporate veil will probably be lifted if the corporation is involved in fraudulent or unlawful actions. To ascertain whether the corporation is being used as a vehicle for criminal purposes, courts should look into the company's financial transactions, business operations, and regulatory compliance.
2. **Degree of Control Exercised by Shareholders or Directors:** Directors and stockholders are more likely to face personal liability if they have exerted significant

[2] Douglas Smith. "Company Law", Routledge, 2018

control over the business. Courts ought to look into the ownership structure, management structure, and decision-making procedures of the business to ascertain the extent of control that the people who founded it possessed.

3. **Extent of Agency Relationship**: If the company's affairs have been conducted in a way that suggests an agency relationship between the company and its shareholders or directors, it is more likely that the corporate veil will be lifted. Courts should examine the company's contracts, agreements, and other documents to determine whether the company is acting as an agent for its shareholders or directors.

4. **Public Interest**[3]: Courts ought to take the public interest in piercing the corporate veil into account. Lifting the curtain may be required to hold those behind the firm accountable if their actions are endangering the public or the environment.

The doctrine of lifting the corporate veil is a complex and nuanced legal principle that requires careful consideration and application. Indian courts must be cautious to distinguish between "peeping behind the veil" and "penetrating the veil" and apply the doctrine only in appropriate cases. By doing so, courts can ensure that the doctrine is applied correctly and fairly, protecting the interests of all parties involved.

The legal doctrine of **Salomon vs. A. Salomon** established that a corporation is an autonomous legal body with its own rights and obligations, distinct from those of its members. A business incorporated by the Companies Act of 2013 is effectively made into a distinct legal entity by Section 9 of the Act, which bestows upon it the attributes of a distinct legal entity, such as possessing:

- Perpetual succession.
- An ordinary seal with the authority to negotiate, buy, hold, and sell property, as well as to sue or being sued under the company's name.

In this instance, Mr. Salomon carried on with his business as a boot maker and leather merchant[4]. initially operated as a sole proprietorship. He started "Salomon & Co. Ltd." as a corporation in 1892. He registered this corporation on behalf of himself, his spouse, and 5 of his children. The family members accepted the ownership stake for Mr. Salomon since the English company law statute required that there be seven shareholders at the moment of transfer. As a businessman, Mr. Salomon intended the Companies Act of 1862 to be accurate. He

[3] John Mugambwa, Harrison Amankwah, C.E.P. (Val) Haynes.
[4] Lorraine Talbot. "Critical Company Law", Routledge-Cavendish, 2019

suggested selling his trade to a limited business made up of himself and six other family members in order to reduce his obligation and give the holder of the preference debenture precedence over other unsecured creditors.

The sole leather company was acquired by the recently founded business. The company of Mr. Salomon was assessed at €39,000. It proved Mr. Salomon's business acumen. The debentures were financed with €10,000, allowing the institution to utilise all of its resources. Shares valued at €20,000 at a price of €1 apiece were purchased by Salomon, who also received €9,000 in cash. At this point, Mr. Salomon purchased company shares for €20,001, with his family member purchasing the remaining six shares. He was a second creditor since he held a debenture.

His personal responsibility for the trade debt had therefore gone from being unlimited to limited. Since Mr. Salomon was also the managing director of the company, he was no longer held personally accountable.

Consequently, in the event that the firm failed, Mr. Salomon would be entitled to collect any remaining assets to satisfy the company's debt to him, in addition to being released from personal liability for the company's debts. As a result, the company that made leather boots faltered, and in less than a year, appellant Salomon was compelled to sell his debenture in order to continue in business. The assets were appraised at €6,000 for obligation, €10,000 for debentures, and €7,000 for unsecured creditors at the time of liquidation. Thus, there would be no money left over for the unsecured loans once the debenture holders received their payout. This company was in insolvent liquidation because it did not produce the necessary results.

Because the corporation was only Mr. Salomon's "alias" or representative, the liquidator asserted on behalf of the unsecured creditors that he was personally liable for the corporation's debt.

QUESTION ASKED BEFORE THE COURT:

1. Was Salomon & Co. Ltd. a legally incorporated company?
2. Was Mr. Salomon personally liable for the Corporation's debts?

ARGUMENTS OF THE APPELLANT SIDE:

1. Mr. Salomon's learnt attorney contended that the Companies Act, 1862, treated the company as a distinct legal entity from its members, hence he was not personally accountable for the Corporation's debts.
2. Learnt Solicitor reiterated that the principle of limited liability applied to the

shareholders, so he was only liable for the total amount of his share capital.

3. Acquired knowledge The lawyer argued that Mr. Salomon, my client, was not accountable just because he owned the majority of the company's shares. As a result, I ask that the honourable My Lords strike the false accusation that the respondents had previously made in lower courts.

ACCUSSATION MADE BY THE RESPONDENTS:

1. Acquired knowledge The appellant's attorney contended that Mr. Salomon manipulated the business to avoid taking personal liability for the company's debts. He ought to be responsible for paying the estimated debt amounts incurred by the company as a result.
2. Acquired knowledge The appellant constructed this 'firm' to avoid his risk, according to the lawyer, who also claimed a majority shareholding in the business. The appellant purposefully created the corporation to mislead his unsecured creditors.
3. The respondent side's lawyer argued that Mr. Salomon did not have the intention of starting this business to increase member profits. His goal was therefore to avoid having to pay off debt.
4. Acquired knowledge The responding side's lawyer argued that the company operated as a fraudulent and dishonest organisation that had stolen money from its debtors in order to put them at danger.

JUDGEMENT:

The House of Lords upheld the appellant's claim that the corporation has a separate legal personality from the shareholders and its members by a slim majority of 3 to 2. They affirmed the Companies Act, 1862, which states that creditors of an insolvent company may not demand payment from the company's investors. The concept of legal personality. As a result, the company that has been established according to the Companies Act is a separate legal entity that is not representing its owner or controller.[5]

The House of Lords proposed that the corporation remained a separate and independent person throughout the appeal, overturning the Court of Appeal's decision. They noted that Mr. Salomon had legitimately incorporated the business because the Act requires a minimum of one share to be held by seven members.

Limited Liability principle applied, meaning that the personal liability of the shareholders and

[5] John Mugambwa, Harrison Amankwah, C.E.P. (Val) Haynes

members could not exceed the value of their participation in the firm's debts. Lord Halsbury contended that the business belonged to the limited company, not to Mr. Salomon, and that the corporation was either a legal thing. Lord Herschell pointed out that numerous businesses had previously been established in which a majority of the stockholders were uninterested parties with little influence over the company.

Indian Recognition:

According to Macaura vs. Northen Assurance Co., a company's property is affiliated with it rather than its sole members, even in cases when the majority shareholder does not own an absolute stake in the company's assets.

"The motives of individuals who took part in the company's promotion are irrelevant in discussing whatever these obligations and rights are," the House of Lords continued[6]and firmly established legal fiction of a "Corporate Veil" between the business & its owners and controllers. The concept of "Separate Legal Personality" is also highlighted in this ruling as a "Double-edged sword"[7]. "There is nothing in the Act that require that the subscribers to the memorandum to be independent or unrelated, or that they or anyone of them have a substantial interest in the undertaking, and that they should have a mind or a will of their own, as one of the learnt Lords Justices seems to think, or that that there be anything like a balance of power within the company's constitution," that is how the House of Lords concluded[8].

The Apex Court recognised that a company's legal character was distinct from its stockholders' in Bacha F. Guzdar vs. CIT, Bombay.2. This position has since been used to establish a "Corporate Veil," separating the existence of a business from its owners (individuals or entities). This curtain, which is only lifted or broken in the most dire circumstances, protects the owners' and executives' best interests. Because a corporation serves as a separate legal body, it is logical to infer that it can be utilised as a cover for illicit activities or to assist dodge legal requirements. In this case, it is possible to pierce the corporate veil in order to –

- Disclose the genuine character of the business
- Determine which people are actually in charge of the business
- Such individuals may be held accountable directly.

Indian courts use the theory of "piercing the corporate veil" or "lifting the corporate veil" based

[6] Commissioners of Inland Revenue v. Gas Lighting Improvement Co. Ltd., 1923 A.C. 723.
[7] PUIG G.V.,A Two-Edged Sword: Salomon And The Separate Legal Entity Doctrine, Corporation law Vol.7(3).(2000).
[8] Salomon v Salomon, [1896] UKHL 1 (Lord Macnaghten) (appeal taken from the Court of Appeal) (UK).

on two theories:

1. The theory of the alter ego states that when a business's owners no longer clearly distinguish between them and the corporation, the latter simply acts as their alter ego in order to engage in illicit activity.
   - The company and the owner share a common interest, and the company's independent legal existence has come to an end.
   - When the business and its owners part ways, the owner's illicit activity comes to light.
2. The instrumentality theory describes the situation in which a company's directors or owners exploit the company's corporate identity for personal gain rather than the company's gain.
   - The business exists only as a tool for the directors and owners.
   - These directors and owners have total authority over the business and utilise it for their personal gain.

III. Reasons to lift the corporate veil

(A) Tax evasion prevention

Often, a corporation will use its corporate structure to avoid paying taxes and other revenue obligations that it would otherwise be obligated to pay under the law. Indian courts have often broken the corporate veil in these kinds of cases to see whether the corporation was using its separate legal existence to avoid paying taxes and revenue duties.

In Commissioner of Income Tax v. Shri Minakshee Mills Madurai, the Supreme Court decided that if a company is being used to avoid taxes, courts have the power to lift its corporate veil and disregard its corporate identity.

The Supreme Court noted in Vodafone BV vs. Union of India5 that the Income Tax agency might remove the corporate veil if it could prove the purported transaction was a means of tax evasion. It was decided that IT authorities may look past the company's corporate shell to see whether it was a Mauritius resident and whether it was filing taxes there.

(B) Closely related companies

Companies that are closely related to one another and sometimes hold a controlling interest in one another might be considered associated companies since they are inherently linked and function as a single entity. The corporate veil theory may be used by the courts to determine the

 [ISSN 2581-5369]

true nature of the enterprises if they are using a corporate structure as a front for illegal activity. Hindalco, the owner of all of Renusagar's shares, obtained energy supplies from Renusagar in the State of Uttar Pradesh v. Renusagar Power Co. case. Hindalco & Renusagar must be considered a one entity, the Supreme Court decided, under the doctrine of lifting the corporate veil. Consequently, the Court found that Hindalco was consuming energy from its own source and that the duty rates applicable to own sources for energy ought to be applied to that use.

(C) **To determine the transaction's true nature**

A company's corporate identity can be utilised as a shield for dishonest business dealings done under the company's name. In these situations, judges may use the theory of "piercing the corporate veil" to determine the true nature of the transactions and hold accountable those who actually exercise power over the company's operations.

In Subhra Mukherjee v. Bharat Coking Coal Ltd., the Supreme Court employed the principle of lifting the corporate veil to determine the true nature of the transaction and pinpoint the parties who were actually involved in the sale. Due to the directors' illegal sale of the company's assets to their wives, the Court found that the transaction among the directors was fraudulent.

In Vodafone International Holdings BV vs. UOI, the Apex Court further noted that when a business abuses its legal structure to transfer money "without appropriate business purpose" or when "the transaction serves principally as a colourable device for the transfer of earnings, profits, and gains" in order to avoid paying taxes, the corporate veil may be lifted.

(D) Public Interest

The public interest justification can also be used to support the corporate veil theory. This might be done in order to put into effect a law that was attempted to be broken by using the company's corporate structure as a means of doing so.

The Supreme Court acknowledged that the corporate veil can be lifted when the public interest justifies it in the case of State of Rajasthan and Ors. vs. Gotan Lime Stones Udyog Ors. By splitting the transaction into two distinct transactions—the first being the conversion of a partnership into a company, and the second being the sale of all of the shares to another company—the corporate entity in this case was used to conceal the true transaction, which involved transferring a mining lease to an outside party in exchange of consideration without statutory consent. The sale of an unlawful mining lease is the actual transaction.

(E) Fraud

Fraud is the most frequent reason to apply the theory of corporate veil piercing. Courts have the authority to rip the corporate veil and hold those in power personally accountable for frauds perpetrated in the company's name when they engage in fraudulent activity while disguising their actions behind company face behind the organisation.

The accused in DDA vs. Skipper Construction Companies (P) Ltd. and Ors. had established multiple businesses and was utilising the facade of corporate identity to deceive people. Using the theory of piercing the corporate veil, the Apex Court determined that the accused was directly responsible for the fraud committed by all of these firms, which were effectively controlled by him.

In OIS Advanced Technology Pvt. Ltd. v. State of NCT of Delhi, the Delhi High Court applied the corporate veil theory to hold those who actually controlled the firm legally accountable. The Court dismissed the shell company's autonomous legal existence, ruling that the defendants were using the organization's corporate identity to protect themselves from liability while engaged in dubious transactions.

(F) Government Company's infringement of Employee and Human Rights

In the case of Kapila Hingorani vs. State of Bihar, a government-owned enterprise was functioning contrary to the welfare of its employees. The corporate veil can be lifted in cases where a company acts contrary justice and the public interest, according to a ruling by the Supreme Court. The court learnt that the state of Bihar was the sole shareholder in the company and that it has direct and significant control over its activities once the curtain was raised. The court also determined that, given its broad and pervasive authority over the industry, the State is obligated under the Constitution to protect the lives and liberties of each and every employee at a government enterprise. As a result, the Bihar government was accountable for ensuring the safety and freedom of the company's workers.

(G) Contempt of Court

The Delhi High Court noted in Jyoti Limited v. Kanwaljit Kaur Bhasin & Ors.12 that the accused had improperly exploited the distinct character of a corporation as a cloak to intentionally disregard the court's instructions. The accused was penalised immediately over contempt of court by the court, which adopted the theory of lifting the corporate veil.

IV. GOVERNMENT COMPANIES

A company may occasionally be seen as acting as the trustee or agent of its shareholders or of another business, and as a result, it may be judged for having lost its individuality in favour of its founder. This is a question that has come up a lot in India about government corporations.

The President along with a few other executives are the shareholders of a sizable number of private firms that are registered under the firms Act for commercial purposes. A government company provides the State with a certain degree of freedom not enjoyed by private companies and escapes rules and procedures that would otherwise impede action when carried out by an agency of the state rather than a government corporation. This is the clear benefit of forming a government company.

Stated differently, it transferred some of the individual's robes to the Government. Furthermore, the Apex court emphasised numerous times that a government firm is neither a branch nor an extension of the State in order to safeguard this freedom. It does not represent the State. As a result, its workers are not considered civil servants, and it is immune from prerogative writs. At one of these situtations, the judge said:

"The company was a non-statutory body as well as incorporated as per Companies act had neither a statutory or a public duty imposed upon it by a statute with respect that its enforcement could be sought through mandamus".

To allow a Development Authority to impose development tax on a government corporation, MP High court deemed the company to be a distinct entity. It was decided that an AP Act did not exempt the assets of an government corporation from paying non-agricultural assessments. A government firm was not permitted to claim the exemption from state taxation that the Central Government property enjoyed. The UP Public Money Act did not apply to a government firm's subsidiary that later became a government corporation. It has been decided that the Steel Authoirty of India is not a state department.

In a similar vein, the Court of Appeal of England declined to rule that transport services rendered by a business in which the Transport Commission owned all of the shares qualified as services rendered "by the Commission or through any person acting as an agent for the Commission." Only when a government corporation is carrying out substantively sovereign or governmental tasks rather than just economic ones will it be considered an agency of the state.

The Som Prakash Rekhi v. Union of India case saw the introduction of a noteworthy by Krishna Iyer J., which is the prioritisation of substance over form. This means that in determining an entity's underlying nature and functions, the court should go beyond its formal structure. In this instance, a new firm was established by the government following the acquisition of Burmah Shell. Despite being officially registered as a private business under the Company Act 2013, Iyer J. contended that the new company's fundamental characteristics were public. The new business was established to carry out a public role, and the government had bought Burmah

Shell in public interest. Thus, the corporation was really a public sector endeavour, regardless of its formal structure.

The conclusion made by Iyer J. deviated from the conventional method of concentrating just on an entity's legal structure. His preference for content over form has had a significant influence on company law since it enables judges to evaluate the real intent behind government acts and defend citizens' rights from capricious or unfair treatment.

He further remarked that the State is the rightful owner, the actual operator, the effective collectorate, and the entity responsible for actions before the public and Parliament. Nonetheless, the firm is run by a separate legal entity with a corporate framework. But keep in mind that although official ownership is shaped by corporations, state control is the reality.

“What we want to emphasise is that, even though Article 12 defines an entity as the Government of India's inclusive agent, meaning that any authority regulated by the state is itself a state, this does not mean that, for the purpose of effectively enforcing fundamental rights, that we should ignore the true nature of that entity. If it turns out to be nothing more than an agent or surrogate for the State, in reality owned by the Government, in truth regulated by the State, and effectively an embodiment of the Government, constitutional lawyers shouldn't disregard these facts and hinder the effective implementation of fundamental rights.”

When LIC exercised its regular authority as a majority stakeholder in a corporation to remove the existing management and reconstitute the Board of Directors, the Supreme Court declined to hold the company as an instrument of the State." In a different instance, the court broke through the corporate veil and determined that, notwithstanding the government's 17.4% stake, the area's Development Corporation was, in reality, a public authority. Its purpose is to construct, manage, and transfer water supply plus wastewater treatment systems through public-private partnership. It turned into a public authority under terms of the 2005 Right to Information Act.

V. AGENTS HAVING NO CONTROL

Consequently, it seems to be exceedingly difficult to convince the courts to look past a company's corporate entity in order to ascertain if it is indeed independent or is acting as a trustee or an agent "in accordance with the ordinary rules of law"

A parent firm or a subsidiary firm, even a 100% subsidiary firm, are separate legal entities, and if there isn't it is not possible to say that of an agency agreement between the two businesses act as the other's representative.

Determining whether Indian corporations are acting as trustees or agents or are genuinely independent presents difficulties. The Supreme Court was put under fire for failing to investigate whether a firm is being employed as a trustee or agent or whether it is truly independent by looking beyond its corporate structure . In the absence of an agency agreement, a parent company and a subsidiary—even a 100% subsidiary—are two distinct legal entities and cannot be regarded as one another's agents.

This type of fact was disclosed by the Smith, Stones & Knight Ltd. Birmingham Corp. facts. After purchasing a partnership concern, a company registered them as a company and proceeded to operate it as a subsidiary.

Except for a small number of shares, the parent firm owned all the shares, chose management, and maintained effective and continuous control. It also viewed the subsidiary's profits like its own. Disregarding the legal distinction among the two companies, the court permitted the parent company to seek compensation for removal and disturbance when the defendant corporation purchased the subsidiary's operations. The parent corporation was represented by the subsidiary, which did not act on its own behalf.

The best proof of agency / trust is complete control over all matters and the absence of any other person's input. Lord Denning, MR, provided an example of how a firm can function as nothing more than the controller operating under a different name. He made extensive use of trusts, corporations, and other legal structures as though they were his own. Without consulting anybody else, he signed massive contracts on behalf of them on a piece of note paper. Since any "one-man company" is run by a single person who also serves as chairman and as a director in addition to owning all of the company's shares, he was willing to acknowledge that the companies are separate legal entities.

The same standards apply to determine whether a business is not a trustee or agent of another entity for taxes purposes. According to Lord Denning MR, courts have the authority to lift the curtain that obscures a limited company's identity and do so frequently.

With regard to group accounts and other matters, the legislature has led the way. Another case in point was FG (Films) Limited, re., wherein an American production firm created a movie named "Monsoon" in India under the legal guise of an English corporation. The court affirmed the Board of Trade's decision to not register the movie as a British production. To claim or think that this small company made arrangements for the film's production would be a blatant distortion of the truth.

In conclusion, it can be difficult for Indian businesses to decide if they are operating as trustees or agents or are genuinely independent, The Supreme Court is currently under criticism for refusing to raise the curtain to determine if a 60% stake in a corporation entitles non-resident Indians to ownership.

*****