INTERNATIONAL JOURNAL OF
LEGAL STUDIES AND
SOCIAL SCIENCES [IJLSSS]

ISSN: 2584-1513 (Online)

Volume 2 | Issue 5 [2024] | Page 11 - 20

BEYOND LIMITED LIABILITY: THE DOCTRINE OF PIERCING THE CORPORATE VEIL

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ABSTRACT

The study explores the legal theory of piercing the corporate veil, which goes beyond limited responsibility to make individual shareholders answerable for the deeds of a company. It looks at the core benefits of incorporation, like limited liability, and emphasizes safeguards against business liabilities that shield owners' private assets. Nonetheless, the piercing doctrine gives judges the authority to deal with cases in which corporate structures are abused to cover up wrongdoing or avoid obligations, enabling creditors to pursue claims against shareholders' assets directly. Instances of fraud, the firm functioning as a proxy for the shareholders, and defending the rights of creditors are important justifications for piercing the veil. By using this theory, courts promote investor confidence and ethical business activities by striking a balance between protecting fair market practices and limiting the abuse of corporate structures. The study goes on to examine Section 339 of the Indian Companies Act, 2013, which gives Indian courts the power to remove the corporate veil when a business is being wound up, especially when there has been fraud. To demonstrate the criteria, courts take into account when deciding whether to breach the veil—such as proof of dishonesty, undercapitalization, or asset commingling—two notable rulings are examined. Additionally, the concept of reverse piercing of the corporate veil is discussed, where creditors seek to hold the corporation accountable for the liabilities of its shareholders. Understanding both traditional and reverse veil-piercing doctrines is vital for corporations and creditors to navigate complex corporate liability scenarios effectively. This analysis underscores the dual role of veil-piercing as a creditor protection mechanism and a promoter of equitable business practices, ensuring that the benefits of incorporation do not become tools for abuse within the marketplace.

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INTRODUCTION

PIERCING OF CORPORATE VEIL

'The Companies Act 2013', defines a company as an establishment incorporated and registered under the act.[2] From the juristic point of view, a company is a legal person distinct from its member. This idea is often regarded as binding on the courts. This idea has the effect of creating a fictitious barrier between the firm and its members; in other words, the corporation has a corporate identity that is separate from that of its members. However, in some situations, the court will penetrate the corporate veil—that is, disregard the corporate veil—to get to the person hiding behind it or to expose the actual structure and nature of the corporation in question. This is most likely justified by the legal prohibition against abusing or misusing the corporation structure.[3] The notion behind a corporation is that it constitutes a distinct legal entity separate from its owners. For this reason, the corporate veil shields the owner against liability for debt and actions of his company.[4] However, there are instances when the corporate veil may be pierced by covert in order to hold accountable certain owners personally. It is from this perspective that this topic seeks to expound on piercing the corporate veil, its purpose and factors used by courts in making such decisions. It is well-established that a corporation is an entity distinct from its shareholders, which provides theoretical support for the notion that the corporation's liabilities—whether tort or contract—are its liabilities and not its shareholders'. Additionally, limiting shareholder liability adheres to a crucial public policy that promotes investment by lowering risks. [5]

One of the major advantages of incorporating a company is limited liability. Shareholders' assets are usually safe from suits brought against their firms. To put it differently, if an organisation goes bankrupt or is sued over its activities, the creditors can only claim for the business assets but not those of shareholders. Such limited liability encourages investment and entrepreneurship as individuals are willing to risk their capital when commencing enterprises.

However, a limited liability shield does not mean it is all-encompassing. Courts may decide to pierce the corporate veil in some particular situations in order to prevent abuse corporate structure. The Supreme Court of the country has emphasized that a company's right to exist as a distinct legal entity from its members is subject to the exception of when a corporate body is used as a front to deceive shareholders

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[2] Companies Act 2013, s 2 (20)

[3] F. Warner, "The Incorporated Individual: A Study of One-Man Company" 51 *Harv LR* (1938).

[4] David H. Barber, "Piercing the Corporate Veil" 17 (1982).

[5] Kent L. Rev, "Piercing the Corporate Veil- the Undercapitalization Factor" 59 *Hein Online* (1983).

and authorities.[6] This effectively removes limited liability protection and permits creditors or victims to seek redress out of personal assets owned by a shareholder.

WHY PIERCE THE VEIL: PROTECTING FAIRNESS AND PREVENTING MISUSE

In layman's terms, to 'Pierce the Veil' means to go beyond the surface or apparent truth to understand the actual or deeper reality. It represents breaking down barriers to reveal the truth or gain deeper insight Courts frequently use a misleading belief that they are administering justice to defend the piercing of the corporate veil, but in practice, this leads to the creation of a legal space where the court has no restrictions and may inflict punishments that suit their perception of justice.[7] The Rwandan Companies Act of 2021 states that "If the court determines that a shareholder has misused the company status form for fraudulent or illegal purposes or abused the company's assets as if they were personal assets, the court may pierce the corporate veil to hold the shareholder liable for obligations of the company." This suggests that if it is believed that the company's members or shareholders utilized the company form for dishonest or unlawful reasons, the courts will have the last say over whether to raise the veil of incorporation.[8] The corporate world commonly depends upon the idea of limited liability. It encourages investors and entrepreneurs by insulating the personal assets of shareholders from company obligations or debts. However, this form of protection is not complete. The courts established an agency link between the controlling shareholder and his corporation in order to create a logical test for removing the corporate veil. If verified, the connection asserted that the business was only the man's agent and lacked any identity of its own. But because it gave judges the authority to arbitrarily deduce the relationship based just on share ownership, this approach was also found to be illogical. If the connection had been built on true information rather than just share ownership, the approach would have been advantageous.[9] The courts are capable of lifting the corporate veil which means that the line between the owners and entity is ignored because they are held responsible personally. This function plays a crucial role in guaranteeing equity, discouraging fraudulent practices, and keeping up with what makes a corporation different.

WHEN THE VEIL GETS PIERCED

It is not within the courts' authority to examine each transaction and determine the best course of action for the firm. However, in order to give the courts, the authority to address those who abuse the concept of

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[6] State of Karnataka v Selvi J. Jayalalitha (2017) Comp Cas 230 (SC)

[7] Macey J and Mitts J, "Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil"" 13 *Oxford Academic*.

[8] Samuel Tuyisenge, "The Concept of Piercing Corporate Veil" *Ssrn* (2022).

[9] Smith, Stone & Knight Ltd v Birmingham Corporation (1939) 4 AII ER 116

a distinct legal entity, the legislation has included measures such as Section 251[10] and Section 7 stated under the Companies Act 2013.[11]Courts may take into account a number of factors before they decide to pierce the veil. These are a few of the most common situations where this can happen.

1) **Alter Ego:** a case where a corporation lacks the character of a separate legal entity. It can occur when the domination of the owners over the corporation is so complete that the owners treat the assets of the company as their own, and there is a failure in maintaining adequate financial records of following corporate formalities. Essentially, the corporation becomes an alter ego of the owners, and the piercing is conducted to hold the owner individually liable for an action of the corporation
2) **Fraudulent Activity:** The court may pierce the veil if a corporation is being used as a tool to hide illegal activity. It might be in the sense that the corporation is being used to divert the assets, hide the income, or for tax evasion in such cases, the owners would not be able to stand behind the shield of limited liability, and the courts can impose personal liability on them for the action of their fraud. The Calcutta High Court ruled in "Commissioner of Income Tax vs Associated Clothiers Ltd (1963) that the veil should only be lifted in extraordinary situations where the statutory provisions are clearly stated. [12]The veil should be lifted in cases where the shareholders have engaged in fraudulent activity or have misrepresented the company in order to deceive the creditors. The Supreme Court of India established in the 1985 case of "LIC India vs. Escorts Ltd. & Others" that, despite the company's status as a distinct corporate personality, the court may, in certain extraordinary situations, lift the corporate veil. These situations include statutory provisions and judicial interpretations.[13]

WHEN CAN SECTION 339 BE INVOKED?

The Indian Companies Act of 2013 has stipulated a clause that has done away with fraudulent business practices. The corporate veil is a term that refers to the difference existing between the company's actions and those of its shareholders. It also frees them from any liability for any acts carried out by the company. [14]In this case, if an entrepreneur engages himself in some illegal activities, they will be held accountable without any limit under section 339 of the Companies Act. This often means that businessmen will personally be liable without restriction.

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[10] Companies Act 2013, s 251
[11] Companies Act 2013, s 7
[12] *Commissioner of Income-Tax, Calcutts* v. *Associated Clothiers Ltd, Calcutta*, AIR1963CAL629

[13] *Life Insurance Corporation of India* v. *Escorts Ltd.*, AIR 1986 SC 1370

[14] Companies Act, 2013, s. sec 339

A corporation offers a distinct legal entity, separate from its owners.[15] This separation grants limited liability, shielding shareholders' assets from the corporation's debts and actions. However, section 339 of the Companies Act, 2013(the Act) acts as a safeguard against abuse of this privilege. It empowers the court to pierce the corporate veil and hold directors, managers, officers or even associates personally liable [16]

This section comes into play specifically during the winding-up of a company, a legal process that involves dissolving the corporation and settling its outstanding debts. For section 399 to be invoked, the court must be satisfied and settle its outstanding debts. For section 339 to be invoked, the court must be satisfied that the company's business was carried on with the intent to

1. **Defraud Creditors** - This includes any action taken to deceive or mislead creditors hindering their ability to recover legitimate debts owed by the company. For instance, diverting assets to benefit specific individuals or hiding profits to avoid paying creditors.
2. **Knowingly Party to Fraudulent Conduct** - This extends liability beyond the company's internal management. Anyone who knowingly assisted or collaborated with the company's fraudulent activities can be held personally accountable. This could include external consultants, accountants or even individuals

Section 339 plays a crucial role in deterring fraudulent business practices and safeguarding the integrity of corporate governance. It encourages directors, managers, and others involved in the company's operations to act with honesty and responsibility. [17]The threat of personal liability serves as a powerful incentive to uphold ethical business practices. Additionally, it offers a sense of justice for creditors and parties who may have suffered losses due to the company's fraudulent activity.

The Companies Act of 2013's Section 339 serves as an essential defense against the fraudulent use of the company structure. It gives judges the authority to cut through the corporate veil and make people personally responsible for the debts of the businesses while they are being wound up. In addition to protecting stakeholders, this clause promotes ethical corporate practices.

[15] Keshav Krishan, Shobhan Sharma, *et.al.*, "Analyzing the Doctrine of Separate Legal Entity and Lifting of the Corporate Veil" 4 *Indian J.L. & Legal Rsch.* (2022).

[16] CA Sharad Kumar Sharma, "Section 339 of Companies Act 2013- Fradulent Conduct of Busines" *Tax Guru* (2023).

[17] IBC, "Section 339 of the Companies Act, 2013: Liability for Fraudulent Conduct of Business" (2014)

WHO CAN BE HELD LIABLE?

Section 339 empowers the court to declare the following individuals personally responsible for the company's debts or liabilities:

1. **Directors, Managers and Officers:** These individuals hold positions of authority within the company and are expected to act in its best interests. If they knowingly participate in or fail to prevent fraudulent conduct, they can be held personally liable.
2. **Knowingly party to Fraudulent conduct:** This extends liability beyond the company's internal management. Anyone who knowingly assisted or collaborated with the company's fraudulent activities can be held personally accountable. [18]This could include external consultants, accountants or even individuals who knowingly benefited from the fraudulent scheme.

The concept of a corporation as a separate legal entity is fundamental to modern business. A core aspect of this legal fiction is limited liability, which shields shareholders from personal responsibility for the corporation's debts and obligations, this principle encourages investment and risk-taking by insulating individuals from the full consequences of business failures.[19]

However, the corporate form is not a license for abuse. To prevent its misuse, courts have developed the doctrine of veil piercing. [20]This equitable remedy allows courts to disregard the corporate entity and hold shareholders personally liable for the corporation's debts or actions.

Typically, courts are reluctant to pierce the corporate veil. The burden of proof lies with the party seeking to pierce it, who must demonstrate compelling reasons to disregard the corporate form. Generally, two primary conditions must be met.

1. **Domination and control:** The shareholders must have exercised complete domination and control over the corporation, this often involves a complete disregard of corporate formalities, such as commingling personal and corporate funds or using the corporate assets for personal purposes.

[18] Preeti Kushwah, "Lifting the Corporate Veil in the Wake of Ecocide: Holding the Parent Company Accountable" 4 *Indian J.L. & Legal Rsch* (2023).

[19] Darshana Paltanwale, "Lifitng the Corporate Veil: A Historical and Jurisprudential Analysis" 56 *Supremo Amicus* (2018).

[20] Anupamma S Neya Dharshini S, "Blurring of Lines Between a Company and its Members in Light of the Doctrines of Piercing and Reverse Piercing of Corporate Veil" 70 *Jus Corpus Law Journal* (2024).

2. **Unjust or Fraudulent conduct:** The dominant shareholder's actions must have led to unjust or fraudulent results, causing harm to creditors or other parties. This might involve using the corporation to perpetrate fraud, evade existing obligations, or avoid statutory requirements.

Courts also consider factors such as undercapitalization, the corporation's failure to maintain separate books and records, and the fraudulent incorporation or operation of the corporation.

The veil-piercing doctrine is a powerful tool to prevent corporate abuse and protect creditors. However, it is also a discretionary remedy applied cautiously by courts. Striking a balance between protecting shareholders and ensuring corporate responsibility remains a complex legal challenge.

While limited liability is essential for fostering entrepreneurship, the veil-piercing doctrine serves as a necessary safeguard against its misuse. By understanding these concepts, businesses can better protect their interests while operating within legal boundaries

WHO CAN INITIATE THE APPLICATION?

The power to hold individuals liable under section 399 doesn't solely rest with the company itself. Several parties can initiate the application process by filing a petition with the National Company Law Tribunal (NCLT)[21]

1. **Official liquidator or company liquidator:** These court-appointed professionals oversee the winding-up process. They must identify potential misconduct and initiate legal action if necessary.
2. **Creditors:** Parties owed money by the company have a vested interest in recovering their debts. If they believe fraudulent activity contributed to the company's insolvency, they can petition the court to hold those responsible accountable[22].
3. **Contributories:** This term refers to members of the company, including shareholders. While shareholders generally enjoy limited liability, they can also apply to section 339 if they believe the company's management engaged in fraudulent conduct that harmed the company's overall financial health.[23]

[21] Aparrjita Singh and Kirit P, "An Analysis on the Doctrine of Lifting of Corporate Veil" 11 *Hein Online* (2022).

[22] Mandhlaenkosi Sibanda, "The Piercing of the Corporate Veil and Creditor Protection" 1 *African Journal of Law and Justice System* (2022).

[23] Preeti Kushwah, "Lifting the Corporate Veil in the Wake of Ecocide: Holding the Parent Company Accountable" 4 *Indian J.L. & Legal Rsch* (2023).

REVERSE PIERCING OF THE CORPORATE VEIL

The predicament when the corporate veil has been breached to make the corporation accountable for the actions, debts, or commitments of its controllers—also referred to as "reverse" veil piercing" (RVP)The UK Supreme Court examined this veil piercing variation in Hurstwood "Properties (A) Ltd and Ors v. Rossendale Borough" Council. Hurstwood does, however, include a significant point in the history of veil lifting since it marks the first formal recognition of reverse veil piercing (RVP).[24]

The traditional concept of piercing the corporate veil allows courts to disregard the separate legal entity of a corporation to hold shareholders personally liable for corporate debts or obligations, conversely, reverse piercing is a less common legal doctrine where the liabilities of a subsidiary corporation are imposed on its parent company.[25]

Typically, courts are hesitant to apply reverse piercing as it can undermine the principle of limited liability. However, in specific circumstances, courts may consider disregarding the corporate form of a subsidiary to reach its parent company.[26]This typically occurs when the subsidiary is so dominated and controlled by the parent that it lacks independent corporate existence.

To establish reverse piercing, a creditor must generally demonstrate:

1. **ALTER EGO OR INSTRUMENTALITY:** The subsidiary is merely a tool to alter the parent's ego, lacking a separate corporate identity. [27]This can be evidenced by commingled funds, shared officers and directors, and the parent's complete control over the subsidiary's operations.
2. **UNJUST ENRICHMENT OR FRAUD:** The parent company has engaged in unjust enrichment or fraudulent conduct by using the subsidiary as a shield to avoid liabilities. For example, transferring assets from the subsidiary to the parent to avoid creditor claims.
3. **UNDERCAPITALIZATION:** The subsidiary was grossly undercapitalized from its inception, indicating an intent to avoid potential liabilities.

[24] Deniz Canruh and Alan Dignam, "Into Reverse: Redesigning Veil Piercing" *Queen Mary Law Research* (2023).

[25] Vijay P Singh, "The Doctrine of Reverse Piercing of Corporate Veil: Its Applicability in India" 27 *Oxford Academic* 108-117 (2021).

[26] Preeti Kushwah, "Lifting the Corporate Veil in the Wake of Ecocide: Holding the Parent Company Accountable" 4 *Indian J.L. & Legal Rsch* (2023).

[27] Vijay P Singh, "The Doctrine of Reverse Piercing of Corporate Veil: Its Applicability in India" 27 *Oxford Academic* 108-11 (2021).

4. **FAILURE TO OBSERVE CORPORATE FORMALITIES:** The subsidiary has consistently failed to maintain corporate formalities, such as holding regular meetings or keeping separate financial records.

It's crucial to note that the burden of proof lies with the creditor seeking to reverse pierce the corporate veil. Courts will carefully scrutinize the relationship between the parent and subsidiary to determine if the circumstances warrant disregarding the corporate form.

While reverse piercing is a powerful tool for creditors, it's essential to balance the interests of creditors with the principle of limited liability. Courts typically apply this doctrine cautiously and only in exceptional cases where the parent company's conduct is egregious.[28]

Ultimately, preventing corporate abuse while preserving the integrity of the corporate form is a complex legal issue. [29]Understanding the doctrine of reverse piercing is crucial for both corporations and creditors to navigate the complexities of corporate law.

FACTORS AFFECTING REVERSE PIERCING

Several factors can influence the success of a reverse piercing claim:

1. **Corporate formalities:** Adherence to corporate formalities, such as maintaining separate books and records, holding regular meetings and issuing shares, makes it more difficult to pierce the veil in either direction.
2. **Undercapitalization:** Inadequate capitalization of the corporation may support a finding of alter ego or instrumentality, increasing the likelihood of both traditional and reverse piercing.
3. **Fraudulent conduct:** Evidence of fraud, misrepresentation or other misconduct by the shareholder or corporation can strengthen a claim for either type of veil piercing.
4. **Nature of the claim:** The underlying nature of the creditor's claim may also be relevant. For example, a claim based on a tort may be more likely to support piercing the veil than a contract claim.

Reverse Piercing of the corporate veil is a complex legal doctrine with limited application. While it provides a potential remedy for creditors of shareholders in certain circumstances, courts generally claim, that

[28] Rahul Mehta, "Piercing the Corporate Veil." 7 *Ssrn* (2021).

[29] Nicholas B Allen, "Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice" *St. John's L. Rev.* (2011).

creditors must demonstrate clear evidence of the corporation's alter ego status, inequitable conduct and the need for equitable relief.[30]

It is important to note that the specific requirements and factors considered in reverse piercing cases can vary depending on the jurisdiction.

CONCLUSION

A fundamental aspect of company law is to stop improper use of the corporate structure to shield individuals from personal responsibility. Although limited liability shields shareholders from direct culpability for company obligations, this does not mean that breaking the law is acceptable. With the help of the penetrating the corporate veil theory, courts can hold stockholders personally accountable for the company's debts and wrongdoings, even though the business has separate legal personality. This authority is used seldom because the majority of courts have already focused on issues like fraud, undercapitalization, and undue shareholder dominance or control. Since reverse veil piercing aims to penetrate the veil of parent corporations or subsidiaries, it differs from common law piercing. The choice of which approach to choose in many situations becomes difficult and requires careful analysis of the situation. under particular, fraudulent transactions are described under Section 339 of the Indian Companies Act, 2013, which also facilitates veil piercing by protecting creditors and promoting ethical corporate practices. This discourages the misuse of limited liability and further integrates corporate accountability. Legal regimes around the world struggle to strike a balance between corporate responsibility and shareholder interests. Piercing the veil protects the interests of creditors and other stakeholders while maintaining the integrity of limited liability, making it an essential defense against corporate wrongdoing. By ensuring that restricted responsibility is not abused at the expense of accountability, the interaction of these ideas creates a favorable economic climate. Since it encourages ethical behavior, this notion is ultimately a vital instrument for attaining corporate governance. It emphasizes that although the limited liability privilege is accessible, there are ethical and legal restrictions to prevent abuses and that there is no absolute entitlement.

[30] Shasthri V, Seshaiah, Bhatt, *et.al.*, "The Doctrine of Reverse Piercing of Corporate Veil: Its Applicability in India" 7 *IUP Journal of Corporate & Securities Law* (2010).