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THE CASE AGAINST 'OUTSIDER REVERSE' VEIL PIERCING IN COMPANY LAW

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The Case Against 'Outsider Reverse' Veil Piercing in UK Company Law: David Cabrelli, Lecturer in Commercial Law, University of Edinburgh

Abstract

For many years, jurists have struggled to rationalise the common law rules which describe the circumstances in which it is justifiable to eschew the principle of separate legal personality which posits that a company is distinct from its members and managers. This is not particularly surprising. The central argument of this article is that in each of the cases where the piercing the veil doctrine has been considered by the courts, claimants have been seeking to harness it as a means of achieving three distinct objectives: first, setting aside the entity shielding feature of organisational law in order to permit the personal or business creditors of the owners (or beneficial owners) or directors (including de facto or shadow directors) of a registered company to seize the assets of the company in priority to the company's creditors ('outsider reverse veil piercing'); secondly, disregarding the institution of limited liability as a means of enabling the creditors of a registered company to seek recourse against the personal assets of the company's owners (or beneficial owners) or directors in precedence to the personal or business creditors of that owner or director; finally, setting aside the separate legal personality of a registered company strictu sensu as a means of achieving an objective unconnected to the foregoing two factors. Once the implications of this are properly understood, an argument emerges which posits that it may be generally undesirable from a doctrinal perspective to permit the common law to set aside the entity shielding function of corporate law and that the application of the doctrine should be confined within limited bounds.

Keywords: Law; Company Law; Corporate Law; Separate Legal Personality; Limited Liability; Entity Shielding; Piercing the Corporate Veil

JEL Classifications: K10; K20; K22; L20; M10; N83; N84

Introduction

The doctrine which sanctions the piercing of the veil of incorporation undoubtedly represents one of the most prominent contributions which the common law has made to UK company law.[1] The doctrine has evolved incrementally on a casuistic basis as a means of avoiding injustices generated as a result of the uncompromising decision of the House of Lords in *Salomon v A. Salomon & Co. Ltd*.[2] which recognised the separate legal personality of companies, duly preferring form over substance. Whilst the common law cases demonstrate that the courts are far from enthusiastic about piercing the corporate veil to enable creditors or other third parties to obtain a remedy, it is not impregnable. Nevertheless, the doctrine has been subjected routinely to criticism. A common accusation is that it is unprincipled, unpredictable and arbitrary in its application. The upshot is that the lack of focus serves to confer too great a margin of discretion in favour of the courts. Further, it is argued that the ascription of discretionary licence to the judiciary is economically inefficient in that it increases transaction costs whilst securing no concomitant social benefits.[3] A similar, related claim is that liberal approaches to veil piercing generate increased borrowing costs for an organisation.[4]

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[1] Of course, there are instances where Parliament has intervened to enable the courts to look behind the cloak of incorporation to hold members or directors personally liable for the debts of the company or generally personally liable, e.g. there are various provisions in the Companies Act 2006 ("the Act") and the Insolvency Act 1986 (section 767(3) and (4) of the Act (directors or officers of a plc), section 563(2) of the Act (directors or officers), section 213(2) of the Insolvency Act 1986 (directors or members) and section 76(3) of the Insolvency Act 1986 (members), inter alia. This paper is concerned with the circumstances which the common law (rather than Parliament) have treated as sufficient to disapply the veil.

[2] [1897] A.C. 22.

[3] SM Bainbridge, "Abolishing Veil Piercing" (2001) 26 *Journal of Corporation Law* 479; SM Bainbridge, "Abolishing LLC Veil Piercing" (2005) *University of Illinois Law Review* 77;

[4] E. Ferran, *Principles of Corporate Finance Law* (2nd edition, Oxford, OUP, 2008) 34;

This article aims to make a modest contribution to the debate on the desirability of maintaining the doctrine as a central component of company law. Jurists have sought in vain to elicit some unifying theory which operates to clarify the circumstances in which the corporate veil has been set aside.[5] Despite such efforts, the search for the juridical basis or bases for the doctrine has proven to be elusive and the cases where it has been applied are generally incapable of being coherently ordered into an organising framework.[6] This article does not go so far as to call for the abolition of the doctrine.[7] Instead, the central argument of this article is that the failure to elicit a satisfactory juridical theory for the doctrine is not particularly surprising when one recognises that in each of the cases where it has been considered by the courts, claimants have sought to harness it as a means of achieving three distinct objectives.[8] Once the implications of this are properly understood, an argument emerges which posits that it may be generally undesirable from a doctrinal perspective to permit the common law to set aside the entity shielding function of corporate law and that the application of the doctrine should be confined within more limited bounds than has hitherto been the case.

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[5] The most recent persuasive attempt is by Moore who argues that the doctrine ought to be based normatively on a 'genuine ultimate purpose' test rather than the 'sham/façade' ground articulated in the courts which he submits is doctrinally unsound, "A Temple Built on Faulty Foundations: Piercing the Corporate Veil and the Legacy of Salomon v Salomon" (2006) *Journal of Business Law* 180. See also S. Ottolenghi, "From Peeping behind the Corporate Veil to Ignoring it Completely" (1990) 53 *Modern Law Review* 33.

[6] E. Ferran, n 4 above, 16-18.

[7] For an exhaustive account of the arguments in favour of abolition from the viewpoint of the economic disadvantages of removing limited liability, see S. Bainbridge, n 3 above.

[8] As stated by Cooke J in *Kensington International Ltd. v Congo* [2005] EWHC 2684 (Comm); [2006] 2 B.C.L.C. 296, 341 at para. 177, the "meaning of the expression ['piercing the corporate veil'] and its out-working differs in the various contexts of the authorities concerned."

Entity Shielding, Limited Liability and Separate Legal Personality

This section seeks to address the import of the terms 'entity shielding', 'limited liability' and 'separate legal personality' and the significance of these factors to the corporate, organisational and legal forms and institutions which are available to persons seeking to engage in commercial enterprise. Once these attributes of the corporate form are understood and organisations and institutions recognised by law are measured and analysed against them, they inform our understanding of, and furnish an alternative perspective against which, the doctrine of piercing the corporate veil can be evaluated. To that extent, this section is engaged in a descriptive exercise.

First, with regard to 'entity shielding', Hansmann and Kraakman have referred to it as 'the *sine qua non* of the legal entity',[9] i.e. that without it, a company could not subsist as a separate juristic person.[10] Nevertheless, suffice to say at this juncture that entity shielding arises in three particular forms, namely 'weak entity shielding', 'strong entity shielding' and 'complete entity shielding'. In the case of the former, the personal or commercial creditors of the owners, directors or managers of an organisation have rights of execution, levy and diligence over the assets of the organisation insofar as the obligations of such owners, directors or managers remain unfulfilled, but those rights of recourse are deferred to the rights of the creditors of the organisation itself.[11] An organisation which exhibits strong entity shielding is one which combines the principle of liquidation protection alongside weak entity shielding. The notion of liquidation protection is channelled through various rule of law which are to the effect that an owner, director or manager is disentitled from forcing the organisation to pay out his share of that organisation at will.[12] In company

[9] H. Hansmann, R. Kraakman and R. Squire, 'Law and the Rise of the Firm' (2006) 119 *Harvard Law Review* 1333, 1338.

[10] It will be argued below that this statement is perhaps taking matters too far.

[11] H. Hansmann et al, n 9 above, 1337-1338; H. Hansmann and R. Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387, 394-395.

[12] H. Hansmann et al, n 9 above, 1338; H. Hansmann et al, n 11 above, 394-395.

law, the capital maintenance principle,[13] the requirement for a super-majority to wind up and dissolve a company[14] and the rule which restricts corporate distributions to being paid out of accumulated, realised profits less accumulated realised losses,[15] are three particular examples of liquidation protection. Suffice to say for the purposes of this paper that we are concerned with 'complete entity shielding', which is a characteristic of the registered company under the Act:

> "*Complete entity shielding* denies non-firm creditors – including creditors of the firm's (beneficial) owners, if any - *any* claim to firm assets... The personal creditors of the managers and beneficiaries of such an organization do not enjoy any claim to its assets, which only bond contractual commitments made in the name of the organization itself."[16]

All companies incorporated under the UK Companies Acts and Corporate Codes and laws in other European countries and North American States, inter alia, possess the characteristic of complete entity shielding, which is one of the defining and unique characteristics of the company. As Hansmann and Kraakman have argued[17] and Armour and Whincop have developed,[18] there are certain features of corporate law which could not be replicated by a series of interlinked contracts which ascribe

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[13] The rules in *In re Exchange Banking Company (Flitcroft's Case)* (1882) LR 21 Ch D 519 and *Trevor v Whitworth* (1887) 12 App. Cas. 409, HL (now subject to section 690 of the Companies Act 2006) to the effect that the capital of the company must not be returned to the shareholders subject to limited recognised exceptions. See also articles 19 to 24 of the Second European Company Law Directive (77/91/EEC) (as amended by Directive 2006/68/EC).

[14] In the UK, see section 84(1)(b) of the Insolvency Act 1986.

[15] Section 830 of the Companies Act 2006 and articles 15 to 16 of the Second European Company Law Directive (77/91/EEC) (as amended by Directive 2006/68/EC).

[16] H. Hansmann et al, n 9 above, 1338.

[17] H. Hansmann et al, n 11 above, 407-408.

[18] J. Armour and M. Whincop, "The Proprietary Foundations of Corporate Law" (2007) 27 OJLS 429.

contractual rights and obligations amongst the natural persons residing behind, and dealing with, the artificial construct of the corporation (e.g. directors, minority shareholders, majority shareholders, employees, suppliers, customers, creditors, etc.). Instead those features require rigid property rules to be promulgated through law to enable them to arise.[19] These rules serve to highlight the proprietary foundations of company law. Complete entity shielding, whereby the assets, and property rights to the assets, of the company, shareholders and directors are rigidly compartmentalised and partitioned is one of those features of the company which it has been persuasively argued cannot be mirrored by multilateral contracting alone.[20]

Limited liability is the mirror image of entity shielding. It operates to disentitle the creditors of an organisation from having recourse against the assets of the organisation's owners, directors or managers for claims which the creditors of the organisation have against that organisation. Like entity shielding, limited liability (what Hansmann and Kraakman have referred to as 'defensive asset partitioning' or 'owner shielding')[21] may be divided into weak and strong forms. The weak form of owner shielding gives the personal creditors of the owners, directors or managers of an organisation a right of recourse against the personal assets of those constituencies for its claims in priority to the creditors of the organisation. Thus, whilst the creditors of the organisation have a right to levy or execute against the personal assets of the owners, directors or managers of the organisation, that right is deferred to the claims of the personal or commercial creditors of such owners, directors or managers. Meanwhile strong owner shielding deprives the creditors of the organisation from any right of recourse against the personal assets of the organisation's owners, directors or managers and they may only levy execution against the assets of the organisation. Finally, the term 'separate legal personality' is simply a reference to the

[19] H. Hansmann et al, n 9 above, 1339 and 1340-1343.

[20] H. Hansmann et al, n 9 above, 1340-1343; H. Hansmann et al, n 11 above, 407-408; J. Armour and M. Whincop, n 18 above, 431; J. Armour, H. Hansmann and R. Kraakman, "What is Corporate Law" in R. Kraakman, J. Armour et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edition, Oxford, OUP, 2009) 6-9.

[21] H. Hansmann et al, n 9 above, 1339-1340 H. Hansmann et al, n 11 above, 395-396.

personification of an organisation which is distinct from its members, owners and managers, i.e. that it resides within the private law category of the law of persons, rather than obligations, things (property) or remedies. A common misconception is that it is only possible for entity shielding and limited liability to arise in the event that an organisation possesses the feature of distinct legal personality, i.e. that it is only because the corporation can be personified that it can own its assets[22] and the shareholders and directors have limited liability. However, as will be demonstrated in the next section, this is a fallacy since each of these three categories are mutually exclusive and none of them are parasitic in the sense that they rely on the continued existence of the others for their recognition or survival.

The Relationship between Entity Shielding, Limited Liability and Separate Legal Personality

It is submitted that none of the institutions of entity shielding, limited liability or separate legal personality are sufficient nor necessary for the others to arise. Each is mutually exclusive and may arise and function in isolation. Instead, the term 'separate legal personality' is a useful concept in the sense of a leitmotif which assists lawyers when they think about the division of assets, and the division of rights to assets, amongst companies and their shareholders and directors.[23] Entity shielding and limited liability are associated with the concept of separate juristic personality, but the latter is by no means a prerequisite for the establishment of both of the former. For example, it is possible for a legal institution to possess both entity shielding and limited liability without separate legal personality. Prior to the coming into force of the Joint Stock Companies Act 1844 and the Limited Liability Act 1855 which established the modern company with strong entity shielding and limited liability, private law mechanisms had been harnessed by practising lawyers to create

[22] That the company owns its own assets is articulated in the speech of Lord Buckmaster in *Macaura v Northern Assurance Company* [1925] AC 619 (Privy Council), 626 and the fact that a share owned by a shareholder does not confer any property right in the assets of the company, *Short v Treasury Commissioners* [1948] 1 KB 116, 122 per Evershed LJ.

[23] J. Armour and M. Whincop, n 18 above, 461.

unincorporated joint stock companies possessing the lion's share of those very features. Such organisations were essentially a highly complex amalgam of large partnerships and trusts whereby the assets of the partnership were vested in trustees selected by the partners in terms of a deed of settlement. Since it had been established by the late 17th century or early 18th century[24] that the personal creditors of trustees could not levy execution against the trust assets of the trustees and that the personal creditors of the trust beneficiaries could not force the liquidation of the assets of the trust estate, the benefit of 'bolting' the trust onto the partnership was that the organisation would enjoy strong entity shielding.[25] Further, limited liability was secured by inserting clauses in the terms and conditions of contracts with creditors of the joint stock company, using the word 'limited' in the name of the joint stock company and specifying limited liability on all official documentation and in contracts with third parties.[26] In the same vein as modern companies, some joint stock companies effectively had transferable shares, perpetual succession and specialised management restricted to a limited number of trustees.

In order to further substantiate the claim that each of the institutions of entity shielding, limited liability and separate legal personality are distinct, it is useful to contrast the Scottish and English partnerships. In the case of the former, the effect of the combination of section 4(2) of the Partnership Act 1890 and the institutional writer Bell's observations[27] is such that it is abundantly clear that the partnership in Scots law is a separate juristic person possessing weak entity shielding (at the very

[24] See *Crane v Drake* (1708) 2 Vern. 616, *Ellis's Case* (1742) 1 Atk. 101.

[25] H. Hansmann et al, n 9 above, 1383-1384.

[26] This technique was effective in the case of trust law, see J. Sears, *Trust Estates as Business Companies* (2nd edn., Kansas City, Vernon Law Book Company, 1921, reprinted by The Lawbook Exchange Ltd. Union, New Jersey, 1998) paras. 39 and 54-56 at pages 53-54 and 74-82.

[27] Bell, *Commentaries*, II, 507-508 (7th edition from 1870 by M'Laren); Erskine *Institute* II, 744; *Commissioners of Treasury v M'Nair*, Faculty Collection, 14 Feb, 1809 and Hume's Lectures Vol. II, at pp. 172, 177 and 183-184.

least). This rule probably emerged 'some time after 1773… [but] before 1800'.[28] There is something quite beguiling about the fact that there are a number of Scots law cases from the late eighteenth century and early nineteenth century which concern the circumstances in which it was appropriate to set aside the personification of the partnership in order to confer benefits on a partnership or the partners of a partnership in actions raised by creditors of a partner or a partnership against a partner or partnership.[29] Indeed, such an issue often arose where the set-off (known as 'compensation' and 'balancing of accounts in bankruptcy' in Scots law) of debts to and from the partnership and the partners was at issue,[30] since it was crucial to identify whether debts were owed to or by individual partners or partnerships in respect of which such individuals were also partners.[31] Further, *a fortiori*, the effect of

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[28] P. Hemphill, "The Personality of the Partnership in Scotland" (1984) *Juridical Review* 208, 216.

[29] Bell, *Commentaries*, II, 515-516 (7th edition from 1870 by M'Laren); *Mackie v M'Dowall* 1774 M. 2575 (piercing argument rejected and so a partnership was not entitled to secure a benefit which would have enabled it to set off a debt due by a creditor to a partner against debts due by the partnership to the same creditor); *Bertram, Gardner & Co.'s* Case, 25th February, 1795 (unreported); *Williams' Trs. v Inglis, Borthwick Gilchrist & Co.*, 13th June 1809, Faculty Collection (veil pierced to provide a benefit to partnership 1 by allowing it to set off sums due by one of its creditors to partnership 2 against sums due by partnership 1 to the same creditor, on the basis that the partners of both partnerships were the same individuals); *Bogle and Bannatyne*, 8th February, 1793 (veil pierced to enable partner to secure a benefit by allowing the set off a debt due to him by a creditor of the partnership against a debt due by the partnership to the same creditor); P. Hemphill, n 28 above, 235. The general rule appears to have been that the commercial objectives of the firms needed to be essentially different for the creditors of a partner of both or all of those firms to be disentitled from setting aside the separate legal personality of those partnerships.

[30] Bell, *Commentaries*, II, 553 (7th edition from 1870 by M'Laren); *M'Ghie v M'Dowall* 1774 M. 2575.

[31] On the basis of the *concursus crediti et debiti* doctrine. For a sharp contrast, see *Ritchie Ltd. v Union Transit Co.* (1915) 32 Sh.Ct.Rep. 55 where it was held that the veil piercing technique was unavailable to permit a director to set off a debt due by his

the rule in *Moss v Elphick*[32] - which it is understood also applies in Scots law[33] - is such that the Scottish partnership exhibits strong entity shielding in circumstances where the partnership agreement declares that it is to endure for a fixed term[34] since it is not competent for a personal creditor of a partner to execute the form of diligence (i.e. the Scots law equivalent of execution or distress) known as adjudication over the assets of a partnership of definite duration.[35] Instead, those creditors have the power to execute the diligence of arrestment over the partner's share in the partnership only and are unable to force the liquidation of the partnership's assets by exercising the

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creditor to a company (of which he was director) against a debt due by him to the same creditor.

[32] [1910] 1 K.B. 846. *Walters* v *Bingham* (1988) 138 NLJ Law Reports 7.

[33] In its Joint Consultation and Discussion Paper on Partnership Law reform, at various points where *Moss v Elphick* was mentioned, the Scottish Law Commission did not qualify matters to suggest that the rule in this case did not apply in Scots law, see Law Commission (Consultation Paper No. 159) and Scottish Law Commission (Discussion Paper No. 111), *Joint Consultation Paper on Partnership Law*, paras. 2.27, 6.8 and 6.18 at pages 12, 58 and 61.

[34] Bell, *Commentaries*, II, 523 (7th edition from 1870 by M'Laren); Partnership Act 1890, ss 26, 32, 33; *Moss v Elphick* [1910] 1 KB 846; Law Commission (Consultation Paper No. 159) and Scottish Law Commission (Discussion Paper No. 111), *Joint Consultation Paper on Partnership Law*, para. 2.28 at page 12. Interestingly, Burgess and Morse suggest that strong entity shielding may also be present where the partnership is at will since the Scottish courts have never 'pronounced upon whether the arresting creditor has the power to dissolve the partnership either at his own hand or by compelling his debtor to exercise his right to do so', R. Burgess and G. Morse, *Partnership Law and Practice in England and Scotland* (London, Sweet & Maxwell, 1980) 170.

[35] Indeed, Clark opined that it might even not be possible in the case of a partnership at will, F. W Clark, *The Law of Partnership and Joint Stock Companies according to the Law of Scotland* (T&T Clark, Edinburgh, 1866), Vol I, p 630-631.

subsequent diligence of furthcoming.[36] The end result is that a 'judgment creditor cannot [force] a division of the firm's assets until the partnership itself is dissolved.'[37]

Turning to the partnership governed by English law, it possesses the same characteristic of weak entity shielding as the Scots partnership by virtue of the case of *Craven v Knight*.[38] *Craven* held that the creditors of a bankrupt partnership have first claim over the assets of that partnership and the personal creditors only have a claim over any surplus left over. Meanwhile, abolishing the old common law rule,[39] section 23(1) of the Partnership Act 1890 provides that execution cannot be levied by a personal creditor against partnership property for the separate debt of a partner. Instead, in terms of section 23(2) of the Partnership Act 1890, that partner's interest in

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[36] Erskine III, 3.24.

[37] P. Hemphill, n 28 above, 228. However, the fact that strong entity shielding in the Scots partnership of fixed duration is not absolute should not be overlooked. For example, the creditors of the partnership may attempt to respond to an express term in the partnership agreement of that kind by engineering a situation which removes strong entity shielding by successfully petitioning for the bankruptcy of a partner, whereupon the partnership will be dissolved automatically and its assets wound up in terms of the Partnership Act 1890, s. 33(1).

[38] (1683) 21 Eng. Rep. 664 (Ch.). See H. Hansmann et al, n 9 above, 1381; J. Getzler and M. McNair, The Firm as an Entity Before the Companies Acts in P Brand, K Costello and W N Osborough (eds), Adventures of the Law: Proceedings of the Sixteenth British Legal History Conference, Dublin, 2003 (Four Courts Press, Dublin, 2005) 267, 278 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941231.

[39] Historically, in English law and the law of the states of the US, it was possible for a judgment creditor of a partner to levy execution and seize the tangible assets of the partnership, see Rt. Hon. Sir N. Lindley, *A Treatise on the Law of Partnership* (5th edition, W. Maxwell & Son, London, 1888) 356; J. Story, *Commentaries on the Law of Partnership as a Branch of Maritime Jurisprudence* (7th edn., Boston, Little Brown & Co. 1881 reprinted by The Law Book Exchange, Ltd, Clark, New Jersey, 2007) para. 261 at pp. 403-405.

the partnership may be charged in terms of a charging order.[40] If the partnership is at will (i.e. of no fixed duration) and the other partners elect under section 33(2) of the Partnership Act 1890 to dissolve the partnership for the reason that the partner's share has been charged, the personal creditors of the partner whose share has been charged will be entitled to force a pay out from the partnership assets, i.e. there will be no strong entity shielding in that case. However, akin to Scots law, the case of *Moss v Elphick*[41] is effective to provide for strong entity shielding in the case of an English partnership where its duration is expressed to be for a fixed term in a partnership agreement and a partner's interest in the partnership has been charged in terms of a charging order.[42] However, unlike the Scottish partnership, in terms of *Sadler v Whiteman*, English law directs that the partnership or firm is nothing more than an expression. Hence, in English law, the partnership may have the attribute of weak or strong entity shielding (depending on the terms of the partnership agreement) without any separate juristic personhood.

It is also possible in practice for an organisation to possess the attributes of separate legal personality and limited liability without entity shielding. For example, consider a private company limited by shares or a plc with one shareholder. In such a case, the creditor of the shareholder may wield sufficient power over that shareholder which enables it to effectively undertake execution (in England) or exercise diligence (in Scotland) over the assets of the company. This can be achieved by the inclusion of appropriately worded covenants in the loan agreement between the creditor and the shareholder, whereupon it is provided that the shareholder is obliged to pass a special resolution under section 84(1)(b) of the Insolvency Act 1986 to voluntarily wind up

[40] See the discussion in Halsbury's Laws of England, (5th edn., 2008) Vol. 79 'Partnership' at paras. 95-96, pp. 61-62. The charging order is enforceable by the creditor by securing the appointment of a receiver or by an order for sale of the partner's share. Nevertheless, like the Scottish partnership, the creditors can effectively discard this strong entity shielding feature by taking steps to make a partner individually bankrupt, since section 33(1) of the Partnership Act 1890 applies.

[41] [1910] 1 K.B. 846.

[42] See the discussion in Halsbury's Laws of England, (5th edn., 2008) Vol. 79 'Partnership' at paras. 95-96, pp. 61-62.

the company on the occurrence of certain events. Such a contractual scheme facilitates the release of the shareholder's share of the assets of that organisation on demand at the behest of that shareholder's creditors. In such circumstances, the liquidation protection mechanisms in company law - such as the provisions which require the super-majority (i.e. a special resolution) approval of the shareholders for the winding-up of the assets of the company and the rules which represent manifestations of the capital maintenance principle duly disempowering both shareholders and their personal and business creditors from compelling the company to pay out the shareholder's share from the net assets of the company – are deprived effectively of any force. Whilst the capital maintenance principle remains intact, the shareholder in such a company can easily bypass it. It is conceivable that the scenario portrayed above could easily be replicated in circumstances where there were a limited number of shareholders in a company rather than simply one.

Furthermore, separate legal personality is not necessary for entity shielding to arise. Here, it is worthwhile recalling that an English partnership at will boasts a weak form of entity shielding in the absence of separate legal personality and limited liability. Such entity shielding may be converted to strong entity shielding by transforming the partnership at will to one of fixed duration, whereupon the rule in *Moss v Elphick*[43] applies to disentitle a partner or his/her personal or commercial creditors from liquidating the partner's share of the assets of the partnership. Furthermore, the rules of property law in jurisdictions bearing a civil law tradition are sufficiently flexible to enable a particular juristic person to partition his assets into separate or multiple asset pools without assigning any juristic personality to such asset pools.[44] The asset pools are referred to as separate special purpose patrimonies ("special purpose patrimonies") and so as long as they are committed or set aside towards the achievement of a specific objective and the property law principles of specificity[45]

[43] [1910] 1 K.B. 846.

[44] G. Elgueta, "Divergences and Convergences of Common Law and Civil Law Traditions on Asset Partitioning: A Functional Analysis", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1395342.

[45] The rule that the property in the pool or fund should be clearly identifiable for real, third party effects to arise.

and *numerus clausus*[46] are respected, the personal creditors of the juristic person will have no right or power to seize the assets or funds falling within those special purpose patrimonies. There are convincing arguments that the Scots law trust functions on the basis of the notion of split patrimonies whereby the trust assets owned by the trustee are ring-fenced from attack at the hands of the trustee's personal or commercial creditors and the latter are unable to force the trustee to liquidate the trust assets as a means of redeeming individual or commercial debts.[47] To that extent, where special purpose patrimonies arise, strong and complete entity shielding without separate legal personality and limited liability is the norm. There is no limited liability since the juristic person is personally liable out of his own private patrimony to the creditors or beneficiaries of a special purpose patrimony in the event that there are insufficient funds or assets therein to satisfy the debts of such creditors or claims of such beneficiaries. However, in much the same fashion as the techniques adopted by unincorporated joint stock companies in the 18th and 19th centuries, it is possible and extremely common for a juristic person through contracting and public notices to

[46] This mandatory principle posits that there is a closed list of circumstances in which it is possible for separate patrimonies to be crafted due to the real, third party consequences which arise and that it is impossible to add to the list by contract alone, See S. Bartels *et al.* in S Bartels and M Milo, *Contents of Real Rights*, 12-22, 29-31, 99-113, 115-147, 149-150 and T.W. Merrill and H.E. Smith, 'The *Numerus Clausus* Principle', 11 *Yale Law Journal* 1 (2000), 3.

[47] G L Gretton "Trusts without Equity" (2000) 49 ICLQ 599; K G C Reid "Patrimony Not Equity: the Trust in Scotland" (2000) 8 *European Review of Private Law* 427. However, this is a theory and there is no common law or legislative support for it. However, the Scottish Law Commission have suggested that the dual patrimony model be put on a statutory footing by legislation, see Discussion Paper No. 133, *The Nature and Constitution of Trusts* (http://www.scotlawcom.gov.uk/downloads/dp133_trusts.pdf), paras. 2.16-2.28 at pages 10-13 and Discussion Paper No. 138, *Discussion Paper on Liability of Trustees to Third Parties* (http://www.scotlawcom.gov.uk/downloads/dps/dp138.pdf), paras. 1.3-1.11 at pages 1-4.

engender limited liability vis-à-vis such special purpose patrimony creditors.[48] Thus, unlimited personal liability is a default rule and the parties are free to contract around it. The point is clearly pronounced when one considers the relevance of limited liability in the context of the lack of separate legal personality of the special purpose patrimony. The discrete special purpose patrimonies enjoy no separate legal personality, since the creditors of each have no right to enforce or take action against the patrimonies themselves. Rather, the claims of those creditors amount to personal rights of enforcement against the juristic person holding, administering or which is responsible for, those assets, albeit that the extent of the latter's liability will be commonly limited by contract to the assets or funds in each special purpose patrimony – rather than extending to the juristic person's individual assets or patrimony.

Implications for the Doctrine on Piercing the Corporate Veil

The above discussion serves to inform our understanding of the piercing the veil doctrine since there is a predisposition to treat each of the cases where it has been invoked as being pre-occupied with the setting aside of the limited liability feature of companies in order to transfer liability onto shareholders and directors.[49] Instead, as Kershaw has correctly noted,[50] this is too simplistic an approach. The doctrine should be analysed in terms of what it definitionally and inherently purports to achieve, i.e. that it functions to explain the circumstances in which the institution of separate juristic personality of the company will be ignored. On this basis, much of the case law on the doctrine of piercing the veil can be examined in a new light, since from the

[48] For example, in Scots law, see *Gordon v Campbell* (1842) 1 Bell's App. 428 and *Brown v Sutherland* (1875) 2 R. 615, 621 per Lord Gifford where it was held that the trust estate was liable where this was expressly stipulated in a contract. In England, the same proposition applies, see *Lumsden v Buchanan* (1865) 4 M 950, 955 per Lord Westbury LC, *Williams v Hathaway* (1877) 6 Ch.D 544 and Halsbury's Laws of England, (4th edn., 2001) Vol. 48, 'Trusts', para. 1080.

[49] S. Bainbridge, n 3 above, 481 and 487; E. Ferran, n 4 above 16; B. Hannigan, *Company Law* (2nd edition, OUP, 2009) 57.

[50] D. Kershaw, *Company Law in Context: Text and Materials* (OUP, 2009) 46.

earlier discussion, it is clear that disregarding the personification of the company does not lead to the personal liability of shareholders or directors as a logical necessity. The preceding discussion relating to the entity shielding feature of companies may also function to assist in pinpointing the circumstances in which the veil of incorporation *ought to*, and *ought not to*, be pierced, ignored or set aside as a means of developing a unifying theory, i.e. the insights which emerge perform a normative, rather than descriptive function. At this juncture, some initial description of the current legal position is required in order to put the ensuing normative arguments within some context.

For such descriptive purposes, it is necessary to briefly engage with the circumstances where it is commonly understood that the doctrine of piercing the corporate veil will be applied. First, it is often narrated that the doctrine will be available where the corporate veil is such that it is a 'mere façade concealing the true facts.'[51] Alternative language for this proposition is where the veil of incorporation is exposed as a 'device or sham or cloak'.[52] A second category of cases are rationalised on the basis that they confer support for a proposition that the doctrine will be applicable where the company has been formed to evade existing legal obligations. For example, in *Jones v Lipman*,[53] where a company had been incorporated to frustrate the performance of a contract for the sale of land entered into between the company's individual shareholder/director and the latter's creditor, the court harnessed the doctrine as a means of granting to the creditor an order for specific performance against the shareholder/director *and* the company. Likewise, in *Gilford Motor Co. Ltd. v Horne*,[54] a creditor of an individual was entitled to an injunction where the individual (through his wife) had incorporated and used a company to breach an obligation owed to the

[51] *Woolfson v Strathclyde R.C.* 1978 SC (HL) 90, 96 per Lord Keith of Kinkel; *Adams v Cape Industries plc* [1990] Ch. 433, 539-541 per Slade LJ; *Trustor AB v Smallbone (No. 2)* [2001] 3 All ER 987, 995f-h per Sir Andrew Morritt V-C.

[52] *Adams v Cape Industries plc* [1990] Ch. 433, 540 per Slade LJ.

[53] [1962] 1 All ER 442.

[54] [1933] Ch. 935.

creditor. Thirdly, grounds such as 'impropriety/mala fides',[55] 'the interests of justice'[56] or 'single economic unit'[57] without more, do *not* provide sufficient explanatory force in themselves for the doctrine. Neither does the agency doctrine represent a ground for the doctrine since it presupposes the existence of the separate personification of the company as a means of transferring liability onto a third party.

Given the difficulties in reconciling the somewhat overlapping and conflicting relationship between the 'mere façade concealing the true facts' and 'evasion of existing legal obligations' bases for the doctrine,[58] it has fallen to doctrinal analysis to seek to forge a normative reconceptualisation of the circumstances in which the doctrine should be applied. For example, Moore has argued that the doctrine ought to be capable of uniform explanation in terms of an overarching theory to the effect that it is applied where a company is not performing a genuine business purpose and instead was formed with some ulterior motives. Whilst attractive, this appears to be a variant of the 'impropriety/mala fides' ground which was rejected in *Trustor*. Further, as Kershaw argues, this formulation 'does not capture the circumstances in which the courts have pierced the veil on the 'mere corporate name' basis… [since] it is clear that using the corporate form to perform a pure liability reduction function, in the

[55] *Trustor AB v Smallbone (No. 2)* [2001] 3 All ER 987, 995f per Sir Andrew Morritt V-C.

[56] *Adams v Cape Industries plc* [1990] Ch. 433, 536 per Slade LJ*; Ord v Belhaven Pubs Ltd.* [1998] EWCA Civ 243; [1998] BCC 607, 614-615 per Hobhouse LJ; *Trustor AB v Smallbone (No. 2)* [2001] 3 All ER 987, 995c-e per Sir Andrew Morritt V-C.

[57] *Adams v Cape Industries plc* [1990] Ch. 433, 539-538 per Slade LJ.

[58] For example, where a company is formed in order to limit a shareholder's potential or anticipated future obligations, this is perfectly legal in terms of *Adams v Cape Industries plc* [1990] Ch. 433, 544 per Slade LJ. The difficulty arises where it comes to drawing the line between existing and anticipated obligations or liabilities, on which see *Raja v Van Hoogstraten* [2006] EWHC 2654 (Ch) at para. 31 per Pumfrey J.

absence of any separate corporate purpose, would not result in piercing under this category.'[59]

It is submitted that the challenges confronting the doctrinal search for a unifying proposition of normative force which serves to explain and guide the future engagement of the doctrine in subsequent cases are not insignificant. Such challenges are attributable to the fact that the doctrine is seeking to achieve three distinct objectives in each of the cases where it has been relied upon. First, it is used to justify the removal of the 'entity shielding' feature of incorporated companies as a means of permitting the creditors of the shareholders (or beneficial shareholders) or directors (including *de facto* or shadow directors) of the company to seize the assets of the company or have residual recourse over those assets as security for an actual or contingent claim against those shareholders or directors ('outsider reverse veil piercing'). Secondly, as has been routinely discussed and documented,[60] the doctrine is applied to remove the 'limited liability' feature of modern company law to enable creditors of the company or other third parties to seize the assets of shareholders (or beneficial shareholders) or directors (including *de facto* or shadow directors) of the company or take security over those assets for an actual or contingent claim against the company.[61] Finally, there is a category of cases where the courts ignore or set aside the separate legal personality of the company *strictu sensu* (A) in order to confer

[59] D. Kershaw, n 49 above 77.

[60] R. Grantham, "Commentary on Goddard" in R. Grantham and C. Rickett, (eds), *Corporate Personality in the 20th Century* (Oxford: Hart, 1998) 65 and D. Prentice, "Corporate Personality, Limited Liability and the Protection of Creditors" in R. Grantham and C. Rickett, (eds), *Corporate Personality in the 20th Century* (Oxford: Hart, 1998) 99; S. Bainbridge, n 3 above, 481 and 487; E. Ferran, n 4 above 16; B. Hannigan, n 48 above, 57.

[61] Some of the most relevant cases are *Adams v Cape Industries plc* [1990] Ch. 433, *Yukong Lines Ltd. of Korea v Rendsburg Investments Corporation of Liberia, The Rialto (No. 2)* [1998] 4 All ER 82 and *Ord v Belhaven Pubs Ltd.* [1998] EWCA Civ 243; [1998] BCC 607, but there are many others.

benefits on (i) the company,[62] or (ii) third parties legally connected in some way to the company (such as parent companies, subsidiary companies, companies in the same corporate group, shareholders[63] or directors) or (iii) third party creditors who are not so legally connected where the benefit accruing to that third party does not entail having actual or potential recourse to the assets of a debtor who is a shareholder of a company or the company itself or (B) for some other purpose which does not entail the removal of entity shielding or limited liability, e.g. the 'mere corporate name' basis referred to by Kershaw above. This article is not so much concerned with the justifications for and against the application of the doctrine to remove limited liability, since those arguments have been well-versed and debated by commentators.[64] Suffice to say that those arguments possess a considerable degree of traction, inasmuch as the doctrine is being applied in such cases in order to set aside limited liability rather than separate legal personality. Removing limited liability does not necessarily entail the disregard of the personification of the company - that necessarily follows from the submission above that these categories are mutually exclusive. Instead, the focus of attention will be on the circumstances in which the common law courts apply the doctrine as a means of disregarding entity shielding, since this is a particular area which has been under-researched.

Applying the Doctrine to Set Aside Entity Shielding

The cases which concern the application of the doctrine sanctioning the piercing of the corporate veil can be classified into two particular groups. First, there are cases

[62] For example, the right of set off. For old cases on piercing the separate legal personality of Scottish partnerships in such a context, see n 29 above.

[63] In the US, where a shareholder is entitled to pierce the corporate veil as a means of securing a benefit, this is known as 'reverse veil piercing', on which see the case of *State Bank v. Euerle Farms, Inc.,* 441 N.W.2d 121 (Minn. App. 1989), discussed in S. Bainbridge, *Corporation Law and Economics* (New York, Foundation Press, 2002) 165-168.

[64] See S. Bainbridge, n 3 above and S. Bainbridge n 61 above at Chapter 4.

such as *Lonrho Ltd v Shell Petroleum Co Ltd (No.1)*,[65] *Kensington International Ltd. v Congo*,[66] *The "Tjaskemolen"*,[67] *Raja v Van Hoogstraten*[68] and others[69] where the doctrine is advanced as a justification for the removal of the 'entity shielding' feature of incorporated companies. The significance of lifting the veil in such circumstances is that it functions to permit the personal or commercial creditors of the shareholders (or beneficial shareholders) of the company to seize the assets of the company as a means of settling a debt, claim or liability. In the US, this approach has been labelled 'outsider reverse veil-piercing'[70] and is recognised as a legitimate cause of action in various US states. For example, in the case of *Litchfield Asset Management Corp. v.*

[65] [1980] 1 WLR 627. Here, the creditors of a parent company sought to gain access to documents held by subsidiary companies in South Africa and Rhodesia, but the claim was rejected.

[66] [2005] EWHC 2684 (Comm); [2006] 2 B.C.L.C. 296. This case concerned a series of sales and purchases amongst connected companies which had a relationship with the Congo or the President of the Congo State Oil Company. The application of the doctrine enabled a creditor of the Congo to seize the assets of companies it controlled directly or indirectly (through the President of the Congo State Oil Company).

[67] [1997] 2 Lloyd's Rep. 465. Here, in anticipation of the initiation of an arbitration claim and the arrestment of a vessel in security for the arbitration claim by a creditor, a company transferred the vessel to another company in the corporate group pursuant to a memorandum of agreement.

[68] [2006] EWHC 2564 (Ch).

[69] *Re K and others; Re M plc and others* [2005] EWCA Crim 619; [2006] BCC 362 is a case based on the application of the Proceeds of Crime Act 2002, s.80(3) involving fraud where entity shielding was removed.

[70] S. Bainbridge, *Corporation Law and Economics* (New York, Foundation Press, 2002) 167-168; L. Heilman, "*C.F. Trust, Inc. v. First Flight Limited Partnership*: Will the Virginia Supreme Court Permit Outsider Reverse Veil-Piercing Against a Limited Partnership?" (2003) 28 *Delaware Journal of Corporate Law* 619; L. Ribstein, "Reverse Limited Liability and the Design of Business Associations" (2005) 30 *Delaware Journal of Corporate Law* 199, 216-219;

Howell,[71] the personal creditors of an individual debtor who owned 97% of the shares of a limited liability company ("LLC")[72] were entitled to apply the doctrine as a means of reaching the assets of the LLC. The second group of cases are slightly different and provide the personal or commercial creditors of the shareholders (or beneficial shareholders) of a company with a right of residual recourse over the assets of the company as a form of security for an actual or contingent claim against those legal or beneficial shareholders. This is an indirect form of 'outsider reverse veil piercing' since it is only if the creditor's right of residual recourse is exercised that the assets of the company are seized and direct outsider reverse veil piercing arises. For example, in *Gilford Motor Co. Ltd. v Horne*,[73] a creditor of a beneficial shareholder of a company was successful in securing an injunction against that individual and the company for a breach of the individual's existing personal obligations. In the event that an injunction is breached by a beneficial shareholder in such circumstances, the creditor in whose favour the injunction has been granted would be entitled to exercise a right of recourse against the assets of the company by enforcing a writ of sequestration.[74] *TSB Private Bank International SA v Chabra*[75] is a similar case

[71] 799 A.2d 298 (Conn. App. Ct. 2002). In the case of *C.F. Trust, Inc. v First Flight Ltd. Partnership* 580 S.E.2d at 811, the Virginia Supreme Court applied the doctrine to an incorporated limited partnership. For a list of cases where outsider veil piercing has been permitted in a number of states in the US, see footnote 32 in L. Heilman, n 68 above, 623, G. Crespi, "The Reverse Pierce Doctrine: Applying Appropriate Standards" (1990-1991) 16 *Journal of Corporation Law* 33, 55-69 and specifically in the case of corporate groups, see R. Thompson, "Piercing the Corporate Veil: An Empirical Study" (1990-1991) 76 *Cornell Law Review* 1036, 1056-1057 at footnote 111.

[72] An entity which is similar to the private limited company by shares in the UK.

[73] [1933] Ch. 935.

[74] RSC, Ord.45, r.5. See *Hospital for Sick Children v Walt Disney Productions Inc.* [1968] Ch. 52.

[75] [1992] 2 All ER 245; [1992] 1 WLR 231. Here, the veil was lifted to enable a business creditor of a director of a company to exercise a Mareva order (now a commercial injunction) against the company, even though it was accepted that the

involving a Mareva injunction. Meanwhile, *Jones v Lipman*[76] concerned the creditor of a shareholder and director of a company who was entitled to an order of specific performance against such shareholder/director and the company, breach of such order naturally entitling the creditor to a right to damages against the company which would be paid out of its assets.[77]

Once it is understood that entity shielding is not a sufficient or necessary consequence of separate legal personality and that both of these innovations are distinct and in fact, that the former is proprietary in nature representing a bedrock feature of corporate law inasmuch as it cannot be simulated or displaced by a nexus of contracts in the absence of exponential costs,[78] an argument emerges that applying the doctrine of piercing the veil to set it aside may be misconceived. The soundness of this reasoning becomes stronger when one considers that in the case of other organisations or legal institutions where weak and strong entity shielding are present or emulated, both are extremely resistant to being set aside, sometimes to the point that such a stance is prohibited outright. For example, in the Scottish partnership, it is not possible for the creditors of a partner to execute the diligences of (i) attachment (formerly poinding) over the corporeal moveable assets[79] of the partnership,[80] (ii) inhibition and adjudication over the corporeal or incorporeal heritable property[81] of the partnership or (iii) arrestment and furthcoming over the incorporeal moveable assets[82] of the partnership – and it is by no means the case that each of these premises are based on the separate legal

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creditor had no cause of action against the company, on the grounds that there was otherwise a risk that the assets of the company would be dissipated.

[76] [1962] 1 All ER 442.

[77] See *Johnson v Agnew* [1980] AC 367 and H. Beale (ed.), *Chitty on Contracts*, (30th edition, Sweet & Maxwell, London, 2008) paras. 27-082 – 27-083.

[78] H. Hansmann et al, n 9 above, 1339 and 1340-1343; J. Armour and M. Whincop, n 18 above.

[79] Tangible personal property.

[80] Section 10(1) of the Debt Arrangement and Attachment (Scotland) Act 2002.

[81] Real property.

[82] Intangible property.

personality of the partnership.[83] Instead, creditors of the partner may only arrest the share of the partner in the partnership, but such a diligence is ineffective to convey title to those assets to the creditor.[84] This begs the question as to how the courts would have treated any plea to apply the doctrine to set aside entity shielding if the organisations in *Gilford Motor Co.*, *Lipman*, *Kensington International*, *The "Tjaskemolen"*, *Van Hoogstraten* and other cases had been Scottish fixed-term partnerships rather than incorporated companies? It is submitted that the weak and strong entity shielding features of the fixed-term partnership would not have been removed to enable the creditors of the partners to take title to, or seize, the assets of the organisation through the technique of outsider reserve veil piercing. Likewise, in the case of the English partnership of fixed duration, it is submitted that the matter would be even more clear-cut. It would resolutely fail to arise on the ground that the doctrine could not be plead since it would be misconceived to do so bearing in mind the absence of any personhood in the case of the English partnership.

The logic in harnessing the doctrine for the purposes of removing entity shielding is further strained when one considers that other legal institutions such as joint property in Scots law[85] harbour no exceptions which have the role of empowering a creditor of a joint proprietor to execute diligence over the joint proprietor's share. A joint proprietor does not own a common *pro indiviso* share in the joint property and so the joint assets are clearly segregated from that person's personal asset pool. Each individual joint proprietor has no power of alienation over his/her notional 'share' and the joint property belongs on a unitary basis to the persons who are joint proprietors, from time to time.[86] To that extent, the title is 'elastic', since if one joint proprietor

[83] P. Hemphill, n 28 above, 227.

[84] See Erskine III, 3.24., G. Gretton, 'Who Owns Partnership Property?' (1987) *Juridical Review* 176, P. Hemphill, n 28 above, 228. The partnership funds are joint property, vested by and in the partners, as joint trustees in the first place for payment of the partnership debts, Bell, *Commentaries*, II, 613 (4th edition). It is only the reversion of them that belongs to the partners as individuals, and to their private creditors (*Commissioners of Treasury v M'Nair*, Faculty Collection, 14 Feb, 1809).

[85] This is different from the joint tenancy in English law.

[86] *Livingstone v Allan* (1900) 3 F 233.

dies, the others take the benefit of the deceased's notional 'share'. The unitary nature of the title ensures that it is not possible for the creditors of an individual joint proprietor to take a right in security or charge over that member's share or undertake diligence over that share.[87] Likewise, in the case of the trust in English law[88] and Scots law,[89] the personal creditors or trustees in bankruptcy of trustees are unable to take title or seize the assets of the trust estate. In Scotland, in the absence of equity, the trustee enjoys the real right of *dominium* in the trust fund/estate, but it is treated as a separate trust/fiduciary patrimony from the trustee's personal patrimony and so is unavailable to his/her personal creditors. The salience of this point is evidenced by the historical data which underscores the significance of the trust device in the commercial sphere in the context of the eighteenth and nineteenth century joint stock corporation and the institution of joint property for the purposes of the Scottish partnership.

In light of these insights, an argument materialises that by applying the doctrine to enable the personal or commercial creditors of shareholders or directors to secure the assets of the company, the limited liability company is being placed at a competitive disadvantage to the Scottish fixed-term partnership, the English fixed-term partnership, the Scottish legal institution of joint property and the English law and Scots law trust. It is self-evident that the partnership form can be used to run a business, but so can the institutions of joint property and trust be harnessed by persons

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[87] K. Reid, *The Law of Property in Scotland* (Butterworths/Law Society of Scotland, 1996) at para. 35.

[88] *Crane v Drake* (1708) 2 Vern. 616, *Ellis's Case* (1742) 1 Atk. 101, *Howard v Jemmet* (1763) 3 Burr. 1369, *Farr v Newman* (1792) 4 Term Rep 621, 645 per Ashhurst J and *Duncan v Cashin* (1875) LR 10 CP 554. See "Trust and Corporation" in Hazeltine et al (eds) *Maitland: Selected Essays* (Cambridge, CUP, 1936) 141, 169 and 196-197, Halsbury's Laws of England, (5th edn., 2009) Vol. 12, 'Civil Procedure', para. 1326 at p. 204 and A. Underhill & D. Hayton, *Law of Trusts and Trustees* (17th edition, LexisNexis Butterworths, 2007), para. 43.3 at p. 567. See also s. 283(3)(a) Insolvency Act 1986 for trustees in the context of the bankruptcy of the trustee.

[89] *Heritable Reversionary Co Ltd v Millar* (1892) 19 R (HL) 43; Bankruptcy (Scotland) Act 1985, s 33(1).

as a means of engaging in enterprise. The general accessibility of the doctrine for these purposes leaves the law open to the accusation that it is incoherent in the commercial context. In itself, the existence of such incoherence may not be wholly objectionable, provided that particularly meaningful reasons can be identified for singling out the corporation for such special treatment. However, it is submitted that one is stretched to detect any merit in applying the doctrine in this fashion, particularly when one considers that entity shielding is one of the proprietary cornerstones of the corporation which underpins the facilitation and ease of transfer of shares thus enabling the creation of a highly stable secondary securities market.[90] Further, if one enables the doctrine to be applied as a means of setting aside entity shielding, this would result in an increase in corporate borrowing costs. The creditors of the company would be deprived of a straightforward means of pricing the cost of credit in order to offset the risk that the creditors of shareholders and others would take priority over their contractual claims.

The argument that entity shielding should not be subjected to disapplication in terms of the doctrine on piercing the corporate veil gains further support when one looks beyond the boundaries of company law to other areas of law. As Armour has argued, other legal institutions which are allied (in the sense of dealing with corporate enterprise) to corporate law but operate outside its field of application, perform functions in the mould of property law which are alternatives to the piercing the veil doctrine.[91] For example, certain institutions enable the creditors of shareholders or directors of corporations to seize or secure the company's assets where they have been transferred from the shareholder or the director to the company. These 'undervalue transactions' laws apply in the context of personal insolvency, e.g. where the assets of an individual or corporate shareholder or director are transferred to the company within a particular period[92] prior to the onset of the personal insolvency of

[90] H. Hansmann et al, n 9 above, 1350.

[91] J. Armour and M. Whincop, n 18 above, 448-462.

[92] In English law, in terms of section 341(1) of the Insolvency Act 1986, the 'relevant time' is 5 years ending with the day of the presentation of the bankruptcy petition on which the individual is adjudged bankrupt, but is 2 years ending with the date of insolvency in the case of a corporate shareholder under section 238 of the Insolvency

the shareholder or director.[93] However, regardless of the state of solvency of the individual shareholder or director, English law enables any transfer of assets from such persons to a company to be challenged in terms of section 423 of the Insolvency Act 1986 where such transaction is entered into at undervalue and a party has been prejudiced as a result. The case of *Dornoch v Westminster International BV*[94] is a good example of this process at work. Here, the court ordered that an asset transferred at undervalue from one company to another in the same corporate group be conveyed to the nominee of a party who had been deliberately prejudiced by, and a victim of, the transaction. In *Dornoch*, the victim of the transaction was an insurance company, but the tenor of the language of section 423 of the Insolvency Act 1986 is sufficiently wide to enable creditors who are prejudiced by a conveyance to seek relief.[95] Whilst Scots law does not travel the same distance as English law, there are common laws based on the *Actio Pauliana* of the Roman law.[96] Like English law, these rules do not require the shareholder or director to have entered into an official bankruptcy proceeding, but they do require a creditor to demonstrate that the shareholder or director was absolutely insolvent in the sense that their liabilities exceeded their assets at the point in time at which the transfer of the assets took place (or that the result of that transfer was the occurrence of such absolute insolvency).[97] Such laws when

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Act 1986. In Scots law, section 34(3) of the Bankruptcy (Scotland) Act 1985 and section 242(3) of the Insolvency Act 1986 stipulate that the relevant period is five years where the transfer is made to an 'associate' and two years in all other cases. Section 74 of the Bankruptcy (Scotland) Act 1985 defines an 'associate' as including various relatives and business associates, employers and employees.

[93] Section 339(3) of the Insolvency Act 1986 and s. 34 of the Bankruptcy (Scotland) Act 1985 for individuals and ss. 238 and 242 of the Insolvency Act 1986 for companies.

[94] [2009] EWHC 1782.

[95] For example, see *Arbuthnot Leasing International Ltd v. Havelet Leasing Ltd (No. 2)* [1990] B.C.C. 636 and *Chohan v. Saggar* [1992] B.C.C. 306.

[96] *Thomas v Thomson* (1866) 5 M 198.

[97] *McCowan v Wright* (1852) 14 D. 968, 970 per Lord Justice-Clark Hope and *Whatmough's Trs. v British Linen Bank* 1934 S.C. (H.L.) 51, 62 per Lord Thankerton.

analysed in their entirety operate as functional equivalents[98] of the doctrine on piercing the corporate veil. Indeed, it is suggested that they are more certain and stronger in their scope of application and the protection which they afford. For that reason, the point is advanced that these 'undervalue transactions' laws are sound alternatives to the doctrine which furnish further support for the contention that the doctrine should not be applied to set aside entity shielding.

The law of agency is another functional equivalent of the doctrine on piercing the corporate veil. In certain circumstances, it may render a company liable to the personal creditors of the shareholders or directors of that company where the former is ruled to be the principal of the shareholders or directors as agents. The personal creditors of the shareholders or directors could seek recourse against the company's assets where the company is deemed to be vicariously liable in tort/delict for the actions or omissions of the former.[99] It is also possible for an agency relationship to arise in a contractual situation where a shareholder or director is held to be an unauthorised agent[100] of the company as principal. If the principal is deemed to have

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See also W. W. McBryde, *Bankruptcy* (2nd edn., W Green, 1995) at para. 12-32 at p. 294.

[98] A term used by K. Hofstetter, "Parent Responsibility for Subsidiary Corporations: Evaluating European Trends" (1990) ICLQ 576, 579 and J. Antunes, *Liability of Corporate Groups* (vol. 10, Studies in Transnational Economic Law, Deventer, Netherlands, Kluwer, 1994) 248.

[99] See S Bainbridge, n 3 above, 484 and the cases of *Parker v Domino's Pizza* 629 So.2d 1026 (Fla. App. 1993) and *Humble Oil & Refining Co. v Martin*, 222 S.W.2d 995 (Tex. 1949) (same).

[100] The doctrine of apparent authority is unlikely to be available as a means of rendering a company liable to a shareholder's personal creditor in agency law, since the debt incurred by the 'agent' would be of a personal nature and it is extremely unlikely that apparent authority would arise in relation to debts incurred outside the ordinary course of business of the company in this way. Further, it is unlikely that shareholders as a class would have apparent authority like the managing director in *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd.* [1964] 2 QB 480.

subsequently ratified (by the nature of its conduct)[101] the agent's actings in seeking to commit the principal to a contract with third parties, the principal will be bound on a retrospective basis from the moment the contract was concluded as if the agent had authority to commit to the contract at that time.[102]

In the case of corporate groups where the parent is the single or majority shareholder of a subsidiary company, there are further mechanisms which operate as functional equivalents of the doctrine. First, there are the common law and statutory devices of *de facto* and shadow[103] directorships. A person is deemed to be a *de facto* director if he/she/it undertakes the function of director, although not formally appointed as such.[104] Moreover, the person must purport to act as a director, may require to be held out as such and must have real influence over the decision-making process of the relevant company.[105] This can be contrasted with the statutory concept of the shadow directorship where a person does not purport to act as a director, but is treated as such on the basis that he/she/it exercises a real influence in the corporate affairs of the relevant company.[106] The notions of *de facto* and shadow directorships are theoretically available to enable a creditor of a shareholder (which is a parent company) to sue a subsidiary company on the basis that the latter is a *de facto* or shadow director of the former and that it breached its statutory duties as a *de facto* or shadow director[107] as a means of holding the latter personally liable. Whilst a breach

[101] It is possible for ratification to occur by the conduct of the principal, *Ballantine v Stevenson* (1881) 8 R 959.

[102] *Alexander Ward & Co Ltd v Samyang Navigation Co Ltd* 1975 SC (HL) 26 at 45, 1975 SLT 126 at 128, per Lord Morris of Borth-y-Gest. See also *Bolton Partners v Lambert* (1889) 41 Ch D 295 at 306, per LJ Cotton.

[103] In terms of section 251 of the Companies Act 2006, this is a person in accordance with whose directions or instructions the company is accustomed to act.

[104] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.

[105] *Gemma Ltd (in liq.) v Davies* [2008] B.C.C. 812, [2008] EWHC 546, Ch., [2008] W.L.R. (D) 89.

[106] *Secretary of State for Trade and Industry v Deverell* [2000] 2 All ER 365 (CA), 372-377 at paras. [24]-[36] per Morritt LJ.

[107] In terms of sections 170 to 178 of the Companies Act 2006.

of the subsidiary's duties as a *de facto* or shadow director of the parent company is not owed directly by it as a director to a creditor of a company,[108] there is nothing to stop a creditor of the parent company from acquiring shares of the parent company where it is publicly listed and then raising statutory derivative proceedings on behalf of the parent against the subsidiary company as directors for breach of duty.[109] Further, if the subsidiary is deemed to be a *de facto* or shadow director, its assets will be available to creditors of the parent company in liquidation if a liquidator is able to show that the subsidiary company engaged in wrongful trading in breach of section 214 of the Insolvency Act 1986. Whilst it would be particularly unusual for a subsidiary company to have a sufficient degree of influence over a parent company or other companies in a corporate group for that matter to satisfy the common law and/or statutory concepts of *de facto* and/or shadow directorships, it is nevertheless worthwhile to underline the potential significance of these provisions.

Secondly, in the context of a corporate group situation, the doctrines of 'enterprise liability'[110] may be invoked as a means of offering relief to creditors in various states in the USA. For example, in cases such as *Gartner v Snyder*[111] and *Pan Pacific Sash & Door Co. v Greendale Park, Inc.*,[112] on the basis of the notion of 'enterprise liability', creditors of one corporation within a corporate group were held to be entitled to reach the assets of other corporations within those groups or the collective assets of the group itself. Control by one corporation of another is insufficient for the

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[108] Rather, the director's duty to take into account the interests of creditors when the company is insolvent or nearing insolvency is owed to the company rather than directly to the creditors. As a result, it is only indirectly through a liquidator acting on behalf of company, that the creditors' interests are represented.

[109] Of course, the shareholder would be required to follow the 'permission to continue' or 'leave to raise' procedures in sections 260 to 264 of, or sections 265 to 269 of, the Companies Act 2006.

[110] P. Muchlinski, *Multinational Enterprises and the Law* (2nd edn. OUP, 2007) 316-326; J. Dine, *The Governance of Corporate Groups* (Cambridge, CUP, 2000) 43-52; R. Grantham, n 59 above, 68-70.

[111] 607 F.2d 582, 588 (2d Cir.1979).

[112] 333 P.2d 802 (Cal.App.1958).

establishment of enterprise liability and instead it is incumbent upon a creditor to demonstrate a high degree of unity of interests between the companies to the extent that it is clear that they did not exist separately on a *de facto* basis. Moreover, such liability will only attach if the result of continuing to ascribe distinctive status to the corporations would lead to injustice.[113] Of course, in the UK, an attempt to import enterprise liability via the label of the 'single economic unit' construct failed in *Adams v Cape Industries plc.*[114] Nevertheless, it is possible that the notion of enterprise liability performs a useful function in the context of the doctrine of vicarious liability where it may be available to enable involuntary tort creditors (such as injured employees) to seek recourse against the assets of another company within the corporate group or a contractor of a debtor company.[115] However, as a result of rapid technological innovations and market techniques such as outsourcing, franchising, dealership networking and privatisation, organisations have vertically disintegrated their production processes with linkages maintained between those organisations via contract-based links, rather than equity-based nexuses.[116] The challenges confronting the enterprise liability model is that its coverage is limited to equity based, rather than contract based, models. For jurists such as Teubner and others,[117] the adaptation of notions of 'network enterprise' liability into a legal system may amount to more satisfactory organising frameworks for the purposes of enabling

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[113] *Las Palmas Assoc. v. Las Palmas Center Assoc.*, 235 Cal.App.3d 1220, 1250 (1991)

[114] [1990] Ch. 433, 532-538 per Slade LJ. However, a limited role continues to exist for this device where a case is on all fours with the facts of *D.H.N. Food Distributors Ltd. v Tower Hamlets London B.C.* [1976] 1 WLR 852.

[115] For example, *R v Associated Octel Co. Ltd.* [1996] 1 WLR 1543. See D. Brodie, "Enterprise Liability: Justifying Vicarious Liability" (2007) 27 OJLS 493, 504-507.

[116] Vertical disintegration is a reference to the process whereby 'new intermediate markets that divide a previously integrated production process between two sets of specialised firms in the same industry [emerge]', M. Jacobides, "Industry Change Through Vertical Disintegration: How and Why Markets Emerged in Mortgage Banking" (2005) 46 *Academy of Management Journal* 465.

[117] See M. Amstutz and G. Teubner (eds.), *Networks: Legal Issues of Multilateral Co-operation* (Oxford, Hart Publishing, 2009).

entity shielding to be disregarded along the whole strata of corporate groups, rather than simply in the case of the subsidiary/parent relationship. The concept's attraction lies in the fact that it affords a means of compensating for some of the negative implications of the operations of corporate groups as it covers non-equity based contractual networks amongst corporations within a group, whereas the enterprise liability model is purely equity-based, i.e. *de facto*, rather than legal control, is the hallmark of the network liability model. Suffice to say for the purposes of this paper that there is limited recognition of such a notion within modern legal systems, albeit that academics are teasing out the possibility of achieving some form of normative reorganisation of private law institutions as a means of extending its scope of application.

Conclusion

One of the striking characteristics of the academic commentary on the doctrine on piercing the veil of incorporation is the general absence of any systematized analysis of the circumstances in which the doctrine is, or ought to be, harnessed as a means of disregarding the entity shielding function of organisational law to impose liability on corporations for the debts or claims of their shareholders, beneficial shareholders or directors. The principal exception is Bainbridge who refers to this process as 'outsider reverse veil piercing'. Bainbridge has argued for the abolition of the doctrine outright and has rightly criticised its application to effect outsider reverse veil piercing on the grounds that other shareholders of the corporation are unjustly prejudiced by its operation.[118] Whilst this is a useful contribution to the debate, it is submitted that the application of the doctrine in outsider reverse veil piercing cases can be subjected to much more forceful criticisms on doctrinal grounds. The revelation that the current law places the registered company at a competitive disadvantage vis-à-vis (i) the Scottish legal institution of joint property and the English law and Scots law trusts when applied in a commercial context and (ii) the Scottish and English fixed-term partnership, functions to supply more forceful justificatory foundations for the abolition of the doctrine as regards its engagement as a means of removing entity shielding. The relevance of other areas of law which supply functional equivalents is

[118] S. Bainbridge, n 61 above 167-168.

also suggestive of the existence of robust alternatives. Further, the strength of the combination of recently introduced statutory innovations such as the wrongful trading provisions in section 214 of the Insolvency Act 1986 and historical common law and statutory concepts such as *de facto* and shadow directorships demonstrate that the territory once occupied by the doctrine of piercing the corporate veil has been encroached upon and with justification that territory should be abandoned and left to these functional equivalents and alternative concepts to cultivate. For all of these reasons, it is argued that there are compelling doctrinal justifications for the proposition that the common law doctrine on disregarding the corporate veil ought to be constrained by the judiciary so that it operates within much more restricted parameters.