Piercing the corporate veil under the New Companies Act

June 1st, 2012

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Is s 20(9) read with s 218 a codification of the common law concept or is it further reaching?

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Before the Companies Act 71 of 2008 was enacted, South African company law was founded in both common law and legislation (specifically the Companies Act 61 of 1973, as amended), developed and further interpreted by judicial precedent. The new Companies Act has now codified directors' duties and has widely extended liability and locus standi.

A company's directors must meet their fiduciary responsibilities and they have a duty to act with care and skill. Directors' duties aim to keep them and the officers of a company accountable for their actions and to promote good governance generally, with guidance provided by guidelines such as the Reports of the King Committee on Corporate Governance in South Africa (King reports). Thus the company directors and officers have both a right and a duty to run the business in the best interests of its shareholders.

The common law notion of piercing the corporate veil is applied to protect the interests of a company's creditors. In many instances this proviso also aims to combat fraud, which is in the public interest.

Section 218 of the 2008 Companies Act extends liability, while s 20(9) codifies the doctrine of piercing the corporate veil. The question of how these aspects will now be applied and enforced is the focus of this article.

Historical background

The common law purpose and scope of piercing the corporate veil

Generally, a company has a separate legal (juristic) personality from its members (the shareholders) and its officers. Any references to a company's officers include its directors, as defined in the 2008 Companies Act. It should be noted that a distinction is made between ownership and management in a company. The management – the company's directors and officers – are mandated to act in the best interests of the company.

In the context of this article, a 'director' means 'a member of the board of a company, as contemplated in section 66, or an alternate director of a company, and includes any person occupying the position of a director or alternate director, by whatever name designated,' as defined in the 2008 Companies Act.

The United Kingdom case of Salomon v Salomon & Co Ltd [1897] AC 22 (HL) confirmed the existence of a company's separate legal personality. Although fiduciary and related duties of directors are owed to the company, the directors' duties are also owed to the company's shareholders, who ultimately share in the company's profits.

Despite the finding in the Salomon case, in Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd [1916] 2 AC 307 (HL) the House of Lords held that the nationality of company members may determine the company's nationality during the First World War.

According to HH Rajak, a specific challenge arises when directors' decisions are influenced by the threat of personal liability: How to balance the interests of creditors and directors by legislative provision (HH Rajak 'Director and officer liability in the zone of insolvency: A comparative analysis' 2008 (11) 1 PER). If the directors' decisions favour the interests of creditors more than the interests of the company – and therefore of shareholders – this may amount to a breach of directors' fiduciary and other duties.

The separate corporate identity of the company can be disregarded when the legislature disregards it in instances of non-compliance with statutory provisions (Dadoo Ltd and Others v Krugersdorp Municipal Council 1920 AD 530). This could, for example, include when a bill of exchange is signed and the registered name of the company is not mentioned; or when business is carried on recklessly or with the intent to defraud in terms of s 424 of the 1973 Companies Act (there is no equivalent in the 2008

Companies Act).

When the veil of incorporation is pierced or lifted, the court acts to strip away the protective covering of the limited liability presented by the company structure. As illustrated by the case of Knoop NO and Others v Birkenstock Properties (Pty) Ltd and Others (FB) (unreported case no 7095/2008, 4-6-2009) (Nxusani AJ), the shareholders can be held personally liable. This happens mostly when shareholders are involved in fraudulent activity, as found in Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others 1995 (4) SA 790 (A); or if shareholders are improperly using the separate legal personality, as found in Robinson v Randfontein Estates Gold Mining Co Ltd 1921 AD 168.

In the Knoop NO case the court held that:

'The corporate veil may be pierced where there is proof of fraud or dishonesty or other improper conduct in the establishment or the use of the company or the conduct of its affairs and in this regard it may be convenient to consider whether the transactions complained of were part of a "device", "stratagem", "cloak" or a "sham"' (see also The Shipping Corporation of India Ltd v Evdomon Corporation and Another 1994 (1) SA 550 (A) at paras 43 to 44).

There have been cases where the doctrine of lifting or piercing the corporate veil has been applied outside instances of commercial abuse or fraud. In these instances the application has extended to eliminating the use of the corporate form to avoid legitimate obligations. It has not, however, been applied lightly – the courts should try to uphold the separate legal personality. The court amplified this notion in the Knoop NO case when it held, at para 14, that:

'When there is fraud, dishonesty or some other improper conduct, policy dictates that the court engages in a balancing exercise. The court considers the circumstances and facts of each case to determine whether, in the appropriate case, it is proper to disregard the corporate personality and apportion liability where it belongs' (see also the Cape Pacific Ltd case at paras 31 and 32).

Sometimes the courts treat the company as a separate legal entity to circumvent problems arising from a strict approach to the corporate entity. However, in these circumstances the courts must avoid the undesirable consequence of holding shareholders responsible for acts of their agent – the company – or incorrectly regarding the company in an inverted manner as an agent of the shareholders. The rules of agency are applied here to regulate a situation for which, in my view, they were not designed (HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delport, L de Koker, JT Pretorius Cilliers and Benade Corporate Law 3ed (Durban: LexisNexis Butterworths 2000) at 14).

Close Corporations Act 69 of 1984

In South Africa the Close Corporations Act was the first to codify the doctrine of lifting the corporate veil. Unlike the company structure, in terms of the Close Corporations Act (now partially repealed by the 2008 Companies Act), the close corporation did not automatically separate ownership and management. Under s 64 of the Close Corporations Act members could be held liable for mismanagement of the corporation.

However, in L & P Plant Hire BK en Andere v Bosch en Andere 2002 (2) SA 662 (SCA) the Supreme Court of Appeal held that the provision should not be applied where the corporation was in a position to meet the debt in question. It should be of no concern to the creditor if the person who acted on behalf of the close corporation has been reckless or even fraudulent. The creditor's only interest is to recover the debt owed to him.

From judgments such as these, it would therefore appear that the purpose of the legislation, as applied by the courts, was to protect creditors rather than to punish errant management.

The future

2008 Companies Act

In terms of s 20(9) of the 2008 Companies Act:

'If, on application by an interested person or in any proceedings in which a company is involved, a court finds that the incorporation of the company, any use of the company, or any act by or on behalf of the company, constitutes an unconscionable abuse of the juristic personality of the company as a separate entity, the court may –

(a) declare that the company is to be deemed not to be a juristic person in respect of any right, obligation or liability of the company or of a shareholder of the company or, in the case of a non-profit company, a member of the company, or of another person specified in the declaration; and

(b) make any further order the court considers appropriate to give effect to a declaration contemplated in paragraph (a).'

This means that interested parties can approach the court, by motion, for an order that the incorporation, use or any act by or on behalf of the company constitutes an unconscionable abuse of juristic personality and to pierce the corporate veil.

According to The Concise Oxford Dictionary (D Thompson (ed) 9ed (Clarendon Press 1995) at 1519), the definition of 'unconscionable' is conduct that is 'unreasonably excessive'. The Free Dictionary defines 'unconscionable' as '[u]nusually harsh and shocking to the conscience; that which is so grossly unfair that a court will proscribe it' (http://legal-dictionary.thefreedictionary.com, accessed 28-4-2012). The use of the word 'unconscionable' denotes that a test heavier than the reasonable man or objective test is to be applied. Does this mean that only cases interpreted as 'serious' will receive this remedy?

In addition, the use of 'may' denotes that it is in a court's discretion in ruling whether or not to pierce the corporate veil, in addition to making any order to enforce the piercing of the corporate veil. This does not deviate much from the discretion the court is usually able to exercise.

Further, the general liability clause contained in s 218(2) of the 2008 Act states:

'Any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.'

Where there has been a contravention of the 2008 Act – including of s 22, which precludes reckless trading by a company – this clause enables parties such as third parties, trade unions, company employees, directors and shareholders to approach court for appropriate relief (and thus extends locus standi).

In terms of s 77 of the 2008 Act, in addition to the previously prevailing common law liability, directors will be liable to the company for any damages or losses resulting from –

a breach of a director's fiduciary duties;

unauthorised trading on behalf of a company or taking part in reckless trading;

being party to acts or omissions that defraud creditors, employees or shareholders, as well as other fraudulent acts;

signing or approving false or misleading financial statements or prospectuses; or

failing to vote against certain prohibited acts.

A director may also be held accountable for his actions when he –

was present at a meeting or

participated in making a decision, and

knew provisions of the Act were contravened (in this context, and in terms of s 1 of the Act, 'knows' means 'that the person either –

(a) had actual knowledge of the matter; or

(b) was in a position in which the person reasonably ought to have —

(i) had actual knowledge;

(ii) investigated the matter to an extent that would have provided the person with actual knowledge; or

(iii) taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter); and

failed to vote against a prohibited act involving, for example, shares issue or the approval of false financial statements.

Therefore, there is an obvious distinction between management accountability to the company and its shareholders and of the company towards its creditors and third parties.

Conclusion

To achieve and maintain healthy economic growth, it is imperative not to disturb the delicate balance between encouraging entrepreneurial initiative and protecting the rights of creditors against fraudulent conduct by an entrepreneur (including by the company as a legal person and its officers).

Considering that the common law concept of piercing the corporate veil has recently been included in s 20 of the 2008 Companies Act – and is not merely an amendment of an existing provision – it is safe to assume that its inclusion was not an oversight, but was rather the legislator's intention.

The courts have traditionally followed a conservative approach in piercing the corporate veil (based on the common law) – even more so in the case of the statutory provision contained in the Close Corporations Act. This is despite there being no inherent separation between management and ownership – which means piercing the veil should theoretically have been applied less conservatively by the courts. In terms of the new Companies Act, the wording of s 20 supports the conservative approach followed under the common law concept of piercing the corporate veil.

In addition, in my opinion, the use of the word 'unconscionable' highlights the court's conservative approach as opposed to the common law position, which was applied conservatively. The distinction, in my view, would now be similar to that of negligence versus gross negligence.

Following on from this, the precious entrepreneurial initiative and the associated balance for the benefit of the South African economy are safe. However, where the Act is contravened, the provisions of s 218 of the Act may serve as a bridge between this heavier onus to pierce the corporate veil and personal liability for damages resulting from contravention of the Act. Attorneys will find themselves in a position where they will have to plead these remedies in the alternative to one another in legal process.

Judicial precedent should clarify the exact application and the degree of the conservative approach the courts will follow. Until such time, I am of the opinion that the remedies enshrined in ss 20(9) and 218 should be pleaded in the alternative.