Lifting of corporate veil in company law

What is Limited Liability?Limited liability is the benefit of incorporation of legal entities.It protects the personal assets of individuals forming and investing in companies when companies fail and become insolvent: ie bankruptcy, but for companies.Limited liability creates an invisible barrier around the personal assets of the shareholders and directors: the corporate veil.The corporate veil enables:people to incorporate a business and avoid incurring further liability if the business is not a success, byring-fencing personal assets of the shareholders: cash held in bank accounts, cars, houses, shares owned in other companies – from those of the legal entity in which they own shares.It is this concept of limited liability that lays the groundwork for the success of modern economies. When "piercing the corporate veil" takes place, limited liability is no longer available to the shareholders and their personal assets are at stake to pay the debts of the company.   Forming a Limited CompanyWhen a company is formed, the word "Limited" forms part of the company name.The use of the word "Limited" in company names was originally required as a warning to those doing business with the company that liability of those involved with the company did not have unlimited liability.   There was a greater risk doing business with a limited company, and still is..The concept of limited liability applies to limited companies and any legal entity which is incorporated.Take as an example limited liability companies which are limited by shares. They're the most common form of company.When the company is formed (ie incorporated) a new legal person is created. That legal entity has all of the attributes of an individual – a human. Just like a natural person the company can:own property: it can buy, sell and own land and any other asset, such as shares, just like an individualsued and be sued: when legal threats are made, they are made against the company. When legal claims are made, they are made by the companyborrow money: ie incur debtShareholders' Liability to CompaniesWhen the initial shareholders – known as subscribers – form the company, they allocate themselves shares in the company. The default value for the shares is £1.00 per ordinary share. (On formation of a private company, it's not compulsory that the consideration for shares is paid straight away. Sometimes it's paid later. But for current purposes, that's beside the point)Then suppose:the company is wound upthat shareholder has not paid for the shares at that pointthe shareholder must pay the total amount due for the shares at that point.That's the amount that the shareholder is liable to pay if it all goes wrong for the company.The same concept applies to other forms of limited companies, and limited liability partnerships. They are separate legal entities, with their own legal personality, which attracts limited liability.Shareholders are investors in the company. They're not the company. They're investing their time or their money in return for a share of the profits of the company. This includes owner-run businesses, and companies with a sole shareholder.Following the example above, suppose that in an insolvency, the company owes £100 to its creditors.None of the shareholders are liable to pay the creditors the sums owed, because company debt is owed by the company to the company's creditors. It's not owed by the shareholders to the creditors of the company.In this way, the personal wealth of the subscribers issued shares are protected if an insolvency situation arises.So:the debts of the company remain the debts of the company, andparent companies are not liable for the debts of insolvent subsidiariesThe general principles apply to anyone owning shares, which could be:an individualanother company, which could be aprivate company limited by sharescompany limited by guaranteepublic company, which is actually public limited liability company. Public companies different from private companies in that they are able to market shares to the public any other type of legal entity that can own property, such as:a limited liability partnership (aka an "LLP")an unincorporated associationThe overarching protection of limited liability applies in each case: the company or LLP that owes the debt, not the individual that owns shares or the partners in the LLP.Individual's Capacities in CompaniesThe same person can be a director, shareholder and employee in the same company. Each of them are different capacities and attract different legal duties, powers and liabilities for wrongdoing.   Examples of the different capacities include:directors owe fiduciary duties to the company, such as acting in the best interests of the company, and not in their own personal interests Fiduciary duties do not equate to a duty of care. A duty of care is a different legal concept which applies in the law of negligence.shareholders do not owe any fiduciary duties to the company and is perfectly entitled to act in their own personal interests when they are exercising the powers granted to them in their capacity as a shareholder. Those powers are exercised in general (aka shareholders') meetings of the companyemployees responsibilities are defined by their contract of employment and the employment legislation. They may owe fiduciary duties arising from their contract of employment.If the employee is also a director, the fiduciary duties arising from their employment may overlap with their fiduciary duties as a director of the company. Any overlap depends on the terms of the terms of the contractual relationship(s) with the company.Directors' Liabilities in a Limited CompanyWhen the company incurs the debt, it is the company that owes the money, and not the individual director(s).It's not correct to say that limited liability extends to directors and employees of companies.That's because directors and employees are agents of the company. When employees and directors work for a company and represent it, they act on behalf of the company.Debts incurred by the company are debts of the company through actions of the directors and employees, and not the debt of any individual director or employee. The law of agency that causes that legal effect.Limited and Unlimited Liability (Personal Liability)If that's limited liability, what's unlimited liability?The limited liability of shareholders in a company contrasts sharply with the unlimited liability of sole proprietors (aka sole traders), partnerships and unincorporated associations.Sole Proprietors and PartnershipsThe exposure to liability of sole proprietors and partnerships (groups of legal entities in business together to make a profit) is unlimited.As unincorporated entities, all of their personal assets and wealth are on the line if the business fails.In the case of unlimited liability of people doing business in their own (aka sole proprietors), partnerships and unincorporated associations:The debts of the business are the debts of the individuals running the legal entityThat's the sole trader/entrepreneur, partnership, or unincorporated association. That's because they are the business. There's no company that runs the business, to create a veil of incorporation of limited liability When the business fails, it's not insolvency of a company, its bankruptcy for each of the entities involved if they can't pay the debts owed to the creditors of the businessIt's unlimited liability because there's no upper limit to the amount that the individuals or partner involved in the business could be found liable. There's no corporate veil of protection in play.Companies in PartnershipsAlso, there's no reason why a company cannot be a partner in a partnership.It happens, most frequently when contractual relationships aren't set up properly. The company is liable for all of the debts of the partnership. The shareholders of those (debtor companies) still have protection of their own limited liability, but the company doesn't.The assets of the individuals and partnerships aren't separate to the business – no matter how you might think of them from an accounting perspective.With companies, the assets are completely separate.Benefits of Limited CompaniesDepending on your perspective, the benefit of a limited company is probably one of:limited liability and its benefits, ortax rates for a limited companies are almost invariably lower than the tax rates which would apply to individuals, when compared to the same business being run by a sole trader entrepreneur or partnership. Companies pay less tax than what sole proprietors do.Less Tax?The headline rates of taxation on turnover of companies is almost invariably less than personal tax rates. But the fact that companies nay be taxed less is only half of the story. In order for a shareholder to get paid, money needs to be extracted from the company.Payments will attract personal taxation, whether the money is extracted as dividends or if in the case of an owner-run entrepreneurs business, the owner-shareholder becomes an employee or consultant (likely to be a director) as well. That then adds another layer of taxation to formation of the company. That is, to extract an income from the company:the company pays tax on the taxable income (which reduces the profits distributable as dividends), and thenthe shareholder pays tax on their own income - whether paid dividends, as an employee or consultant - within the prevailing tax bands which apply to taxable income of individuals.That's two layers of tax when a company is involved. Other Benefits of Limited Companies   Starting a limited company makes sense to avoid unlimited liability of trading in person.The other benefits follow from that, such as:reduction of personal risk: not lying awake at night wondering if you're going to be called on to pay the debts of therisk management: a higher level of corporate certaintyinvestment: other companies might choose to invest money or loan into the business, safe in the knowledge that that other company's or individual's assets aren't on the line if things go wrong. Limited liability attracting investment at limited personal risk to the investor shareholderswider investment pool: they say that investors invest in people, not companies. But that's only half the story. Rare is the case that they would put their own personal wealth at stake, over and above what they would be prepared to invest. Investors would be less likely to stake their own money available if limited liability wasn't available to shelter their own assets, beyond what they were prepared to willing risk on the investmentDisadvantages of Limited LiabilityTo obtain the benefits of liability, there's a price.And that's playing by corporate rules. Incorporation – which is required to obtain limited liability – requires a series of filings each year, and updates to the status of named internal affairs of the company within fixed time frames.A limited company (private and public) have series of filing requirements which include:confirmation statementsannual accountstax returns to the HMRCThe first two above are filed with Companies House so that those outside the company have access to at least some information about the company. Company information which is disclosed includes names of the directors, the shareholders and their respective shareholdings, and (very) basic financial information, particularly for micro-companies. A balance sheet may be all that is available on a company search for 12 months trading activity. Ownership of Company AssetsOne of the fundamentals of incorporation is that the assets of the company are owned by the company.They're not owned by:one or more of the shareholdersthe majority shareholder, oreven in a company with one director and a single shareholderThat means that a shareholder taking assets of the company is:well, stealing, and a criminal offence andconversion (the civil law cause of action for stealing) by the shareholder, which gives the company the right to recovery of the property or damages.Exceptions to Limited LiabilityLimited liability does not protect shareholders in all circumstances, come what may in all situations. Shareholders can be required to pay debts incurred by the company when the corporate structure is abused.Corporate VeilThe concept of limited liability is the concept that gives rise to – or is - the corporate veil.Creditors are not able to recover debt from the personal assets of the shareholders, directors or employees. It must recover them from the assets of the company, and the company alone.ExampleSalomon v Salomon (1897) was the case that first affirmed the difference that limited liability and with it the corporate veil.In that case, an individual – a sole trader named Mr Salomon – had run his business in his own name: as a sole proprietor. He incorporated the business, that is:Mr Salomon formed - incorporated - a company. He named it A. Salomon & Co LimitedMr Salomon transferred ownership all of the assets which he used as part of his personal business to the new company A. Salomon & Co LimitedA. Salomon & Co Limited was the business (as a separate legal entity) that Mr Salomon used to run in his own nameSo, when the company traded, the contracts of sale of goods and services were contracts between A. Salomon & Co Limited and the customers, not Mr Solomon and the customers.The company:had its own legal personalitywas not doing business for Mr Salomon, the company was the business:was not the agent of Mr Solomonwas the principal: it was the business.In this way, incorporation creates:an invisible barrier around the assets of the shareholders and directors, which is the veil of incorporationprotects personal fortunes in the event of insolvency as a result.Provided nothing is done by the shareholders to expose themselves to legal liability, creditors can't recover debt from them.Their personal wealth is insulated from recovery by the creditors to the company.Piercing the Corporate VeilWhen an exception applies to the protection given by limited liability, it is referred to as "piercing the corporate veil", "lifting the corporate veil" or "raising the curtain of incorporation".When it is lifted by the creditors it:makes the shareholders liable for the debts of the companygets at the personal assets of the shareholders,to use those assets to recover the debts of the company to creditors.An exception allows creditors to get at the shareholders to establish personal liability against the shareholders: unlimited liability.Piercing the corporate veil has the net effect (legally speaking) of treating the company and the shareholders as one, single legal entity.The exceptions apply in limited circumstances. They're exceptions to the rule in Salomon v A. Salomon and Co Ltd.Evasion of Legal DutyIn Petrodel Resources Ltd v Prest (2013) the Supreme Court decided that the corporate veil will not protect shareholders where:there is a legal right against the person in control of it which exists independently of the company's involvement, and a company is interposed so that the separate legal personality of the company will defeat the right or frustrate its enforcement.In those cases, courts can disregard the corporate veil.When a company's separate legal person is abused for some relevant wrongdoing, court are more likely to be justified piercing the corporate veil.It's known as the evasion principle. It's when companies are used by those in control of it to evade a legal liability that the individual would otherwise have had (if it weren't for the corporate veil).The corporate structure must be abused by those controlling the company to pierce the corporate veil and lose the benefit of limited liability. That usually takes the form of:such misuse of the company,fraud, such as wrongful trading and insolvent tradingmalfeasance orevasion of legal obligationsPiercing the corporate veil is a remedy of last resort, because personal liability of the individual abusing the corporate veil can usually be established by other means.It has a limited application, because, as the Supreme Court said in Prest:in almost every case where the test is satisfied, the facts will in practice disclose a legal relationship between the company and its controller which will make it unnecessary to pierce the corporate veil.It's this availability as a last resort that's explained by the concealment principle. Concealment of WrongdoingThis is usually the first port of call for attempts to establish liability against shareholders.It is personal liability in the sense that the individual – being a shareholder or directors has committed a wrongful act which attracts personal liability in its own right.Contrasted with evasion are attempts to conceal wrongdoing with use of corporate structures.The concealment principle [...] does not involve piercing the corporate veil at all. It is that the interposition of a company or perhaps several companies so as to conceal the identity of the real actors will not deter the courts from identifying them, assuming that their identity is legally relevant. In these cases the court is not disregarding the "facade", but only looking behind it to discover the facts which the corporate structure is concealing.So when a separate legal entity is used to attempt to find shelter from liability (such as doing an act through a company rather than through the same company or as an individual), the pre-existing legal obligation can't be avoided by using a separate legal entity. Limited liability does not come into it, because the legal liability is personal to the actor involved.The classic example is fraud. In Standard Chartered Bank v Pakistan National Shipping Corporation [2002] UKHL 43, Lord Hoffman said:No one can escape liability for his fraud by saying "I wish to make it clear that I am committing this fraud on behalf of someone else and I am not to be personally liable."So in the case of a shareholder behaving fraudulently, the shareholder is personally liability for the fraud. The corporate veil doesn't come into it to protect the shareholder, because liability for the fraud arises independently of ownership of any shares in a company.Other common examples for establishing personal liability include – which usually results in the company and the individual being sued:contracts made by the shareholder in question with a third party, such as a personal guarantee:personal guarantees give rise to personal liability because a direct legal relationship is made between a lender and the guarantorrestrictive covenants to avoid anti-competition agreementsjoint liability for a tort: such as infringement of intellectual property rights or the tort of conversion (roughly speaking, the civil law of theft)conspiracy with third parties, and perhaps where the company is a [joint tortfeasor][link]assumption of responsibility, where the shareholder takes on responsibility for a particular risk in the course of providing professional servicesConclusionThe expressions "lift the corporate veil", "lift the curtain of incorporation" and "pierce the veil of incorporation" describes the:legal effect of getting past the shelter given to the shareholders and directors of companies; andmeans by which a court will disregard the separate personality of the company. It's establishing personal liability against a director or shareholder for some sort of unlawful behaviour done in the name of the company. The unlawful behaviour disentitles them to the protection of limited liability.The unlawful behaviour requires (1) dishonest conduct of some degree, or (2) conduct so reprehensible that the person should not have the benefit of limited liability.