**Question 3**

**The Court of Appeal missed the opportunity in Adams v Cape Industries plc [1991] 1 All ER 987, to modernise the law on piercing the corporate veil in this jurisdiction. The result is that the law on this topic remains confused and confusing; worse, it is positively unfair to creditors. Discuss.**

The Companies Act 1862[1] laid down an axiomatic principle of law allowing companies to be "incorporated" to limit the liability of their members to their share capital, such that "no member of a company is personally liable for the debts, obligations or acts of the company"[2]. In Salomon v Salomon 1896[3] the House of Lords applied this statute to establish what is now known as the "corporate personality" of an incorporated company as distinct from its shareholders, such that even when the company is majority owned and directed by one party, it is *the company* that acts, and *the company* is liable. The company becomes an autonomous legal entity, so much so that it now even enjoys human rights protection[4], though not to the same extent as natural persons[5]. This principle inherently involves tension with the fundamental tenet of vicarious liability under respondeat superior, restricting it and preventing liability reaching the members in control of the company.

The law in this country considerably favours and rigidly adheres to the Salomon principle[6] rarely permitting "piercing the corporate veil" to confer liability on members, though there are exceptions. This essay will analyse the law governing the circumstances under which these exceptions are permitted, with particular reference to corporate group structures. In doing this

[1] Companies Act 1862
[2] Ibid s55
[3] Salomon v Salomon & Co. Ltd. [1897] A.C. 22; (HL)
[4] European Convention of Human Rights
[5] Emberland, M, 'The Human Rights of Companies - Exploring the Structure of ECHR Protection' (2007) 32(3) *E.L. Rev*, pp. 419-422
[6] Scanlan, G, 'The Salomon principle' (2004) 25(7), *Comp. Law* pp. 196

 

a key case, Adams v Cape Industries plc 1991[7] will be discussed and its outcome criticised, whilst some possible routes to reform will be noted.

Prior to Adams v Cape Industries[8] it was established that a company could not be automatically treated as the agent of its shareholders[9], though the veil of incorporation could be lifted in some circumstances. In Gilford Motor Co Ltd v Horne[10] an action was brought for the breach of a restraint of trade clause, whereby the defendant solicited the plaintiff company's customers though a private limited company. Lord Hanworth enunciated that the company "was formed as a device, a stratagem, in order to mask the"[11] the defendant, highlighting his unsavoury motive in forming the company, and thus permitted a lifting of the corporate veil to find him liable. This precedent has since been reiterated and accepted such that it is now a recognised exception when "special circumstances exist indicating [the company] is a mere façade concealing the true facts"[12]. Then in Smith, Stone and Knight v Birmingham Corp[13] a parent purchased a subsidiary company and carried on the subsidiary as if it were an internal department of the parent, with only single member of staff. Under these rare circumstances the court held that the subsidiary was in fact carrying out the business of its parent, and was thus acting as its agent, such that the parent could be found liable.

Then in the 1970's and 80's a number of key cases tested how the courts would treat corporate groups. In D.H.N. Food Distributors Ltd v Tower Hamlets LBC[14] Lord Denning expressed the view that, at the request of the holding company, a wholly owned subsidiary should be pierced to allow rights to be conferred on the holding company when the companies

[7] Adams v Cape Industries Plc [1990] Ch. 433
[8] Ibid
[9] See Gramophone & Typewriter Co Ltd v Stanley [1908] 2 KB 89
[10] Gilford Motor Co v Horne [1933] Ch. 935
[11] Ibid at 955
[12] Woolfson v Strathclyde 1978 S.C. (H.L.) 90 per Lord Keith of Kinkel
[13] Smith, Stone & Knight & Co v Birmingham Corp [1939] 4 All ER 116
[14] DHN v Tower Hamlets [1976] 1 W.L.R. 852

were in effect a "single economic entity"[15] with the subsidiaries "bound hand and foot"[16] under the complete control of the parent. This case achieved justice for the appellants but muddied the waters concerning the application of the Salomon principle for corporate groups, as the necessary degree of domination over the subsidiary, was no-where specified. In Woolfson v Strathclyde Regional Council[17] the House of Lords cast doubts on the reasoning in the D.H.N. case, suggesting that the principle only to pierce "sham" companies had been misapplied, and distinguished from its ruling based on the fact that D.H.N controlled its subsidiaries "in every respect"[18] whereas Woolfson did not. However despite this retrenchment, the courts seem consistently reluctant to pierce a corporate group for the benefit of strangers to it. For example in Multinational Gas v Multinational Services[19] the Court of Appeal denied a liquidator recompense from any of a subsidiary company's three parents, and in Lonrho Ltd v Shell Petroleum Ltd[20] the House of Lords refused to follow an order of discovery through to a holding company to obtain documents from a foreign subsidiary.

In Adams v Cape[21] the Court of Appeal made a landmark decision when claimants brought an action trying to enforce a judgement against a foreign subsidiary of Cape Industries made by a court in Texas, against its parent under English jurisdiction. The Court of Appeal sought to determine whether the parent company could be said to be present in the foreign jurisdiction via its subsidiary by considering 3 possible arguments. Firstly the "single economic entity" argument made by the House of Lords in the D.H.N. case was considered and dismissed; judging that regardless of the economic realities there was "no general principle"[22] allowing a group of companies to be treated as a single entity. Slade L.J. explained that previous cases

[15] Ibid at 853
[16] Ibid at 860
[17] Woolfson v Strathclyde 1978 S.C. (H.L.) 90
[18] Ibid at 96
[19] Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd [1983] Ch. 258
[20] Lonrho Ltd v Shell Petroleum Co Ltd [1982] A.C. 173
[21] Adams v Cape Industries Plc [1990] Ch. 433
[22] Ibid at 532

that seemed to speak to the contrary had turned on the "wording of a particular statute or contract"[23], and that the court was "not free to disregard"[24] the Salomon principle merely for justice sake.

Having decided that the corporate veil could not be pierced simply due to the economic realities, it was considered whether the relevant subsidiaries, A.M.C and C.P.C, acted as façades to disguise the presence of Cape in Illinois. Evidence was presented demonstrating Cape's motive was to conceal its continued trading of asbestos in the United States, however the court held that the motive in creating the subsidiary must be legally relevant, not just unfair. It was decided that although the veil could be pierced when a company was created as a "sham" to evade existing legal limitations and 3rd party rights against it, it could not be pierced when created to evade future rights that others might acquire[25]. It was held that it was inherent in English law that the corporate structure could be used to cause liability to fall on another member of a group, and thus the veil could not be pierced.

Finally it was argued that N.A.A.C and C.P.C acted as agents for Cape. The court made it clear that agency would only be found where it was clear that Cape's business was being carried out, and not that of the subsidiaries themselves. The judges came to the decision that although both N.A.A.C and C.P.C were created as the marketing agents of the Cape group in the USA, they carried out their own business and adopted a communicatory role, nursing Cape's customers in the region and coordinating sales, rather than making them. Although subject to Cape, they both engaged in business with other suppliers, and so the fact that they acted as agents for Cape in some transactions was not sufficient to show that Cape itself was

[23] Adams v Cape at 535
[24] Adams v Cape at 536
[25] See Adams v Cape at 544

present[26]. It was thus held by the Court of Appeal that Cape Industries were not present in the United States and so were not under the jurisdiction of the Texas court.

The precedent set by this case treats members of corporate groups as entirely separate entities, favouring a legal formalism over business realities, irrespective of justice, and legitimises the use of the corporate form to enable parent companies to create subsidiaries in order to evade future rights that others may acquire against them. It seems strange that whilst for justice sake it can be distinguished from Salomon when a company is incorporated with the motive to deceive and evade existing limitations, the courts claim to be unable to do so when it is a mere puppet of a parent company created solely to shield itself from future limitations. Even in the former the level of impropriety in the motive required to allow the veil to be pierced is "notoriously uncertain"[27]. The insistence of Slade L.J that the corporate veil may only be pierced where a company is clearly a sham, maintained the autonomy of the corporate form whilst allowing future courts to curtail the most harmful cases and prevented the floodgates that appealing to issues like fairness might have opened, but like all of the exceptions discussed earlier, was not developed using a normative approach. Rather, the literal and therefore permissive interpretation of the incorporation requirements taken by the court in Salomon, forced the courts to develop all these exceptions in an "ad hoc" way, to avoid manifestly unjust or nonsensical rulings in extreme cases.

In fact it has been argued that the reasoning in Adams has served to ignore the original basis for piercing the corporate veil, which lies in much earlier jurisprudence concerning the "head and brains" rule and the "cloak or sham rule" [28]. Two years after Salmon in Apthorpe v Peter

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[26] Ibid at 548-9
[27] Hawke, N, 'Corporate liability: smoke and mirrors' (2003) 14(2), *I.C.C.L.R.* at 75-82
[28] Moore, M, 'A temple built on faulty foundations: piercing the corporate veil and the legacy of Salomon v Salomon' (2006) Mar, *J.B.L*, at 182

Schoenhofen Brewing Co[29] it was held that an English parent who took over the majority share and the ultimate direction and control of an American company, was "carrying on" business in the United States as the parent company were undoubtedly the "head and brains" of the foreign operations, even though the subsidiary retained responsibility for the day to day running. Despite its submission, Smith L.J. disregarded the impact of the Salomon decision regarding the autonomy of the two companies addressing the question instead as a matter of *fact*[30], claiming that it was not relevant to the facts. Then in Gilford Motors[31], Farwell J. felt justified in piercing the veil between J. M. Horne & Co Ltd and Mr Horne himself without question, providing moral justification, but basing legal justification not on Salomon, but on an even earlier case, Smith v Hancock[32]. The judgement in Salomon claimed that the courts were powerless to deny someone their limited liability without legislative provision[33], and in fact none of the judges in Gilford referred expressly to Salomon. A more convincing view of Gilford would be that it is incompatible with Salomon, and so far from affirming a consistent general basis for piercing the corporate veil, its authority should have been limited to cases with similar facts[34]. Thus the "sham" exception to the Salomon principle as affirmed in Adams, far from having its roots in Salomon itself, developed independently though a number of cases with dismissive references to the Salomon judgement.

A more satisfactory basis for piercing the corporate veil, which reconciles these divergent bases, has been argued as being possible using the "genuine ultimate purpose"[35] rule, which looks at whether the subsidiary is active or passive in relation to its parent. Thus when a subsidiary is formed for a purpose which precedes and exists independently of the activity

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[29] Apthorpe v. Peter Schoenhofen Brewing Co. Ltd. (1899) 4 T.C. 41, C.A
[30] Ibid, *per* Collins L.J., at 60
[31] Gilford Motor Co v Horne [1933] Ch. 935
[32] Smith v Hancock [1894] 2 Ch. 377
[33] Salomon [1897] A.C. 22 *per* Lord Davey at 54
[34] Moore, M, 'A temple built on faulty foundations: piercing the corporate veil and the legacy of Salomon v Salomon' (2006) Mar, *J.B.L*, at 191
[35] Ibid

giving rise to dispute, it could be classed as active and legitimate, as it is not simply a passive tool wielded by the parent, but actively carries on of its incorporators business. This rule allows Adams to be distinguished from Salomon as in the former the company's incorporation was motivated primarily by the desire to protect against potential liability, rather than in the case of the latter where it was motivated by other factors and served a genuine goal of the incorporator.

However although such measures could bring clarity to the confused jurisprudence in this area, it still fails to achieve justice for creditors. For example there have been a number of occasions where a holding company has set up a thinly financed subsidiary that has subsequently become insolvent[36]. Despite the fact that the parent has considerable control over the running of its subsidiary, the courts have demonstrated that creditors cannot look to the parent for debts owed by the subsidiary[37]. In fact the subsidiary may be financed largely by a loan from its parent, secured on its assets, making the parent a preferential creditor such that upon insolvency the parent has priority over other unsecured creditors. Not only are parent companies immune from the debts of their subsidiaries, they are also free to act in a way detrimental to the subsidiary, as their duty is only to themselves. For example in 1994 a company called Pentos forced its subsidiary Athena out of business with outstanding debts of £7m[38]. Although this has been mitigated somewhat by Insolvency Act 1986[39], the parent's dominating position is clearly unfair to creditors, as the parent maintains all the benefits of profit and control, without any of the obligation or risk[40].

[36] See Re A Company [1985] BCLC 333 (CA); Creasy v Beachwood Motors [1993] BCLC 480; Templeman LJ in Re Southard & Co [1979] 1 WLR 1198
[37] Stapledon, G.P., 'A parent company's liability for debts of an insolvent subsidiary' (1995) 16(5), *Comp. Law*, 152-153
[38] See 'Suppliers left holding the baby' (1995) Financial Times, 17 January, p 14.
[39] Insolvency Act 1986
[40] Wilkinson, A, 'Piercing the corporate veil and the Insolvency Act 1986' (1987) 8(3) *Comp. Law*, at 127

The fundamental issue is that of control. A parent company has two roles: firstly that of a shareholder, but secondly as a controller. The problem arises because "the law in England fails adequately to attribute any responsibility to a parent in this [later] role"[41]. A creator cannot be liable for all the acts of his creation, but he can for those acts committed in obedience to his continuing dominion over it. Unlike a normal shareholder, a parent company retains considerable power over its subsidiary, and yet owes no duty to it. This less than arms length control and thus obedience in the relationship is key, as the parent becomes the subsidiary's alter ego or "directing mind and will"[42], though the courts dispute this, claiming the subsidiary is capable of breaking the chain of causation[43]. As was mentioned at the start, this conflicts with the notion of vicarious liability where the parent should have the "right, ability or duty to control" the subsidiary. The statutory definition of a group relationship recognises this concept of control, basing the test of the presence of such a relationship not on shareholding, but on majority voting rights[44]. However save in extreme cases the judiciary confer no duty upon the controlling shareholder, allowing him complete control of his puppet whilst sheltering behind the veil of limited liability. This is particularly unfair to victims of torts, as unlike creditors, they cannot negotiate around it[45], and are unlikely to appreciate the increased investment and managerial risk taking that it enables.

Despite these problems, it might have been unwise if such fundamental principles of law had been overhauled by the judiciary overnight. When the veil can be pierced the courts immediately face problems with apportioning blame. Thus although the court had an opportunity to modernise the law in Adams, they chose to take the course of least resistance,

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[41] Schulte, R, 'Corporate groups and the equitable subordination of claims on insolvency' (1997) 18(1) *Comp. Law*, at 2
[42] See Stocznia Gdanska SA v Latvian Shipping Co (Repudiation) [2002] EWCA Civ 889
[43] Hawke, N, Hargreaves, P, 'Corporate liability: smoke and mirrors' (2003) 14(2) *I.C.C.L.R.* at 80
[44] See Companies Act 1989 section 736(1)
[45] Ferran, E, Company Law and Corporate Finance (Oxford, Oxford University Press, 1999) pp. 31

 

to allow the legislature to intervene and reform this area in a normative way. Investigations into such reform were made by the Cork Committee in 1981[46], but a fundamental change was avoided as it would involve changing other parts of company law, such as the duties of the directors of holding companies, and instead a full review was recommended "as a matter of urgency"[47].

Other jurisdictions have adopted various methods to address these problems. Canadian law bears most similarity to that of this jurisdiction, but provides more room for exception when the subsidiary is under "the complete control of the parent"[48]. In the USA the principle of "equitable subordination"[49] has been used since the 1930's to specifically address the problem of insolvent subsidiaries, by allowing the courts to re-order creditor priority based on fairness, subordinating the priority of irresponsible parent firms below any unsecured creditors. The German "law of integration"[50] has produced a far more structured system based on "enterprise contracts" and rules for "de facto groups", stemming from the concept of "group danger" assuming that a controller will always sacrifice its subsidiaries interests for its own[51]. Here corporate groups either have implicit or explicit corporate constitutions which give the ruling company the majority management power and responsibility, in exchange for a "pecuniary claim" held by the dominated against the dominator. It is this approach that formed the basis for the ECJ's ruling in Istituto Chemioterapico v. Commission of the European

[46] Insolvency Law and Practice, Report of the Review Committee (Cmnd 8558) 1982.
[47] Ibid para 1952
[48]Hargovan, A, Harris, J, 'Piercing the corporate veil in Canada: a comparative analysis' (2007) 28(2) *Comp. Law*. at 58
[49] Schulte, R, 'Corporate groups and the equitable subordination of claims on insolvency' (1997) 18(1) *Comp. Law*, at 4
[50] See Wurdinger, H, *German Company Law* (Oyez Publishing, 1975), Chapter 2, pp 138-40
[51] Dahnert, A, 'Lifting the corporate veil: English and German perspectives on group liability' (2007) 18(11) *I.C.C.L.R*, at 396

 

Communities[52] and that may one day be incorporated into EC law as was proposed in the defunct Ninth Draft Directive[53].

In conclusion the law governing the piercing of the corporate veil in this country is currently highly convoluted, and has shaky doctrinal origins. Most disturbingly justice has been suppressed by the policing of archaic boundaries, due to the impotence of the legislature to reform an area of law which fails to adequately cater for modern economic reality. Parliament should not wait for some eventual EC harmonisation, but as was recommended in the Cork report should review corporate group law in this jurisdiction "as a matter of urgency"[54].

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[52] Istituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v. Commission of the European Communities (Cases 6 and 7/73) [1974] E.C.R. 223
[53] Ninth Draft Directive on Company Law, Commission Document, III/1639/84-EN
[54] Insolvency Law and Practice, Report of the Review Committee (Cmnd 8558) Para 1952.

 