The lifted veil

Dov Ohrenstein provides a reminder of the law of corporate credit representations

Dov Ohrenstein is a barrister at Radcliffe Chambers

Frequently, when a creditor discovers that a debtor company is insolvent, the creditor will want to recover the debt from a shareholder, director or associate of the insolvent company. Although attempts by shareholders to lift the veil to claim reflective losses will not usually succeed (see *Johnson v Gore Wood* [2000]), there are various statutory and common law mechanisms by which the corporate veil can be lifted. This article sets outs and discusses those mechanisms in the light of recent authorities.

Principles of corporate personality

One of the fundamental principles of company law is that a company has a personality that is distinct from that of its shareholders. This rule was laid down by the House of Lords in *Salomon v Salomon & Co* [1897], in which it was held that even if one individual held almost all the shares and debentures in a company, and if the remaining shares were held on trust for him, the company is not to be regarded as a mere shadow of that individual. Lord Macnaghten stated at paragraph 51:

> The company is at law a different person altogether from the subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or the trustee for them. Nor are subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the [Companies Act (CA) 1862].

The rule in *Salomon* lies at the heart of corporate personality, and is the principal difference between companies and partnerships. However, there are situations in which the courts look beyond that personality to the members or directors of the company. In doing so they are said to lift or pierce the corporate veil. There is no single basis on which attempts by shareholders to lift the veil to claim reflective losses may proceed. Rather the cases fall into several loose categories, which are examined below.

Despite the doctrine of the corporate veil a corporate body can only have knowledge by the attribution of the knowledge of a natural person. The question of whose knowledge counts as the knowledge of the company depends on the interpretation and purpose of the particular substantive rule that requires the knowledge of an individual to be treated as the knowledge in possession of the company. See *Lebon & anor v Aqua Salt Co Ltd* [2009] and *Jafari-Fini v Skillglass Ltd & ors* [2007].

'There are situations in which the courts look beyond a corporate personality to the members or directors. In doing so they are said to lift or pierce the corporate veil. There is no single basis on which attempts by shareholders to lift the veil to claim reflective losses may proceed. Rather the cases fall into several loose categories.'

Statutory exceptions

There are certain statutory exceptions to the rule in *Salomon* which involve a director being made liable for debts of the company because of breach of the companies or insolvency legislation. These include:

Failure to obtain a trading certificate

Where a public company fails to obtain a trading certificate in addition to its certificate of incorporation before trading, the directors will be liable to the other parties in any transactions entered into by the company to indemnify them against any loss or damage suffered as a result of the company's failure to comply with its obligations. This provision in s117(8) CA 1985 has been retained in s767(3) CA 2006.

Failure to use company's name
Section 349(4) of CA 1985 provided that if an officer of a company or a person acting on its behalf signs a bill of exchange, cheque or similar instrument on behalf of the company, in which the company's name is not mentioned (thus contravening s349(1)(c) CA 1985), that person will be personally liable to the holder of the instrument in question for the amount of it (unless it is duly paid by the company). However, although s84 CA 2006 imposes criminal penalties for failure to use the company name on relevant documents, there is currently no equivalent provision in CA 2006 imposing such a personal liability.

Disqualified directors
Under s15 of the Company Directors Disqualification Act 1986, if a person who has been disqualified from being a director of, or involved in the management of a company acts in contravention of that disqualification they will be liable for all debts of the company incurred while they were acting in that way. The same applies to a person who knowingly acts on the instructions of a disqualified person or an undischarged bankrupt.

Just and equitable winding up
Under s122(1)(g) of the Insolvency Act (IA) 1986 a petition may be presented to wind up a company on the grounds that it would be just and equitable to do so. This may involve lifting the corporate veil, for example to examine the basis on which the company was formed. See *Ebrahimi v Westbourne Galleries* [1973].

Fraudulent trading
Section 213 of IA 1986 deals with fraudulent trading. Under that section, if it appears to the court that 'any business of the company has been carried on with intent to defraud creditors of the company or of any other person, or for any fraudulent purpose', it may order that:

> ... any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make contributions (if any) to the company's assets as the court thinks proper.

Wrongful trading
Section 214 of IA 1986 concerns wrongful trading, and enables the court to make a declaration, when a company has gone into insolvent liquidation, that a former director is liable to make a contribution to the company's assets. Such a declaration can be made where the director in question knew or ought to have concluded, at some point before the commencement of the company's liquidation, that there was no reasonable prospect that the company would avoid going into insolvent litigation. By s214(7), the provisions of s214 also apply to shadow directors.

Phoenix companies
The Insolvency Act 1986 also allows the court to lift the corporate veil in cases of 'phoenix companies', in which a new company is created with the same or a similar name to an insolvent company. Section 216 of IA 1986 makes it an offence for anyone who was a director of the insolvent company during the 12 months before liquidation to be associated with a company with the same name as the insolvent company or a name so similar as to suggest an association (unless that person is given leave by the court to act in that way: s216(3)). Section 217 provides that where a person is involved in the management of a company in contravention of s216, or where they act, or are willing to act, on instructions given by a person whom they know to be in contravention of that section, they are jointly and severally liable with the company for all the relevant debts of that company.

Unfair prejudice
The courts' powers under s459 CA 1985 (the provisions of which are duplicated in s994 CA 2006) apply where:

> ... the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself).

The general proposition that the conduct of a parent company in control of a subsidiary can be relevant where a petition is presented by shareholders of a subsidiary is unsurprising. It has also been held by the Court of Appeal in *Statek Corporation v Alford & anor* [2008] that directors' unfairly prejudicial conduct of a subsidiary may be actionable by shareholders of the parent if the parent and subsidiary have directors in common.

Where a public company fails to obtain a trading certificate in addition to its certificate of incorporation before trading, the directors will be liable to the other parties in any transactions entered into by the company.

Common law and the mere façade test
It has long been established that the courts will not allow the *Salomon* principle to be used as an engine of fraud, or to avoid pre-existing legal obligations. Probably the best-known example of this rule is *Gilford Motor Company Ltd v Horne* [1933], in which the defendant had been managing director of the claimant company, and had entered into a covenant not to solicit customers from his employers when he ceased to be employed by them. On leaving the company's employment, Horne formed a company to carry on a competing business, the shares in which were held by his wife and a friend, and he thereby solicited the claimant's customers. The Court of Appeal held that this company was a mere façade or sham to cloak his breach, and granted an injunction to enforce the covenant against both Horne and the company.

Representations as to creditworthiness
Only rarely will the concepts of a sham or agency assist in the process of attaching liability to a director or shareholder of an insolvent company. Proving that a company is a sham can be difficult, particularly if the company is long-established, and agency will not normally be relevant. Further, the statutory remedies against directors for wrongful and fraudulent trading

(s213-214 IA 1986) are of limited assistance to most creditors since:

- they depend on the company being wound up and action being taken by the liquidator; and
- any sums recovered are shared among all the various creditors.

A director will not be treated as liable with a company as a joint tortfeasor if they do no more than carry out their constitutional role in the governance of the company.

In November 2007 the Court of Appeal in *Contex Drouzhba v Wiseman* [2007] made clear that there is an alternative remedy for many of those creditors. This alternative is to claim directly against the directors for fraudulent representations as to creditworthiness and to overcome the hurdle of Lord Tenterden's Act (the Statute of Frauds (Amendment) Act 1828).

As explained in *Standard Chartered Bank v Pakistan National Shipping Corp & anor (no 2)* [1999], a director will not be treated as liable with a company as a joint tortfeasor if they do no more than carry out their constitutional role in the governance of the company, eg by voting at board meetings. Similarly, a controlling shareholder will not be liable as joint tortfeasor for doing no more than voting at general meetings and appointing directors.

Nevertheless, there is no reason why a person who happens to be a controlling shareholder or director should not be liable with the company as a joint tortfeasor if that person is not exercising control through the constitutional organs of the company and the circumstances are such that they would be liable if they were not a director or controlling shareholder. In the context of intellectual property the potential for joint tortious liability of individuals who have responsibility for the control of a company, alongside the company, is of long standing. *Rainham Chemical Works Ltd v Belvedere Fish Guano Co Ltd* [1921], *MCA Records Inc & anor v Charly Records & ors* [2001] and *Contex Drouzhba* [2006] applied this principle to the tort of deceitful misrepresentations as to creditworthiness. In *Contex Drouzhba* the defendant was a director of a company which he knew was in a weak financial position. To obtain goods for the company, the director signed a document which was given to the claimant suppliers stating:

> 6. Payments: bank transfer made to the account of the performer [the claimant] made not later than 30/thirty days after the shipment.

It was held that:

- this document clearly contained a promise by the company to pay for goods to be ordered in the future;
- the director, by signing the document, impliedly represented that the company had the capacity to meet its obligations to pay for goods to be ordered thereafter; and
- the representation was fraudulent, as the director knew that the company did not have that capacity and had no chance of gaining it.

The director was thus a joint tortfeasor in respect of the deceitful misrepresentation. Paragraph 96 of the judgment stated:

> It cannot ever have been the policy of the law that a director of a company who commits acts amounting to deceit and at the same time procures acts amounting to deceit by the company of which he is a director should be able to claim exemption from tortious action because of his status as director.

Paragraph 97 continued:

> Since the essence of the case is representations as to the Company's credit which were almost all in fact made by [the director] himself, the analysis must be that [the director] both made those representations personally and procured the company to make them… Here [the director] controlled everything closely, while most of the representations were made by [the director] personally, they were necessarily made on behalf of the company. Insofar as the representations as to credit consisted of orders placed pursuant to various agreements, they were also made on occasion by other company employees under the direction of [the director]. In my judgment, this is a situation where the individual director and the company may be joint tortfeasors.

When *Contex Drouzhba* came before the Court of Appeal no permission to appeal was given on the general principle of the director's joint liability. The only issues which concerned the Court of Appeal were defence arguments based on s6 of Lord Tenterden's Act (the Statute of Frauds (Amendment) Act 1828). This provides that:

> No action shall be brought whereby to charge any person upon or by reason of any representation or assurance made or given concerning or relating to the character, conduct, credit, ability, trade, or dealings of any other person to the intent or purpose that such other person may obtain credit, money, or goods upon, unless such representation or assurance be made in writing, signed by the Party to be charged therewith.

This legislation, although antique, is still in force. It applies only to fraudulent representations. For an action for false representation as to creditworthiness to be maintained, the representation as to the credit of another person must be signed by the person making it, and not by an agent. 'Person' for this purpose includes a company. In *Contex Drouzhba* it was contended unsuccessfully on behalf of the director that the only representations made by the director were by conduct or implied representations, and therefore outside the section. As Waller LJ pointed out:

> Certainly, if the judge is right, it appears that there may be situations in which, by the signing of contracts by directors where those directors are guilty of fraudulent trading, creditors may have a direct remedy against the director in deceit, and a remedy that avoids the consequences of sections 213 and 214. Those consequences flow from the finding of an implied representation of the type found in this case (against which there is now no appeal), together with a finding that the contract satisfies the above section of Lord Tenterden's Act.

The Court of Appeal held that Irwin J was right to impose liability on the director and that Lord Tenterden's Act provided no defence. Importantly, the fact that a representation can only be implied from the terms of a written document rather than being an express term was held not to assist the director. To impose personal liability there is no need for any express representations as to creditworthiness, so long as there is something in writing signed by that person.

For an action for false representation as to creditworthiness to be maintained, the representation as to the credit of another person must be signed by the person making it, and not by an agent.

In cases where there is merely a representation by conduct the requirements of Lord Tenterden's Act (ie signed writing) are not met. However, *Contex Drouzhba* indicates that directors can be exposed to personal liability even if all they do is sign an order form. This case is therefore likely to have far-reaching consequences. ■

Contex Drouzhba Ltd v Wiseman & anor
[2007] EWCA Civ 1201;
[2006] EWHC 2708 (QB)

Ebrahimi v Westbourne Galleries
[1973] AC 360

Gilford Motor Company Ltd v Horne
[1933] Ch 935

Jafari-Fini v Skillglass Ltd & ors
[2007] EWCA Civ 261

Johnson v Gore Wood
[2000] UKHL 65

Lebon & anor v Aqua Salt Co Ltd
[2009] UKPC 2

MCA Records Inc & anor v Charly Records & ors
[2001] EWCA Civ 1441

Rainham Chemical Works Ltd v Belvedere Fish Guano Co Ltd
[1921] 2 AC 465

Standard Chartered Bank v Pakistan National Shipping Corp & anor (no 2)
[1999] EWCA Civ 3028

Salomon v Salomon & Co
(1897) AC 22

Statek Corporation v Alford & anor
[2008] EWHC 32 (Ch)