| Subject | COMMERCE |
|---|---|
| Paper No and Title | 10 CORPORATE LEGAL FRAMEWORK |
| Module No and Title | 02 COMPANY-AN INCORPORATED ENTITY |
| Module Tag | COM_P10_M2 |


| Principal Investigator | Co- Principal Investigator | | Co- Principal Investigator and Technical Coordinator |
|---|---|---|---|
| **Prof K V Bhanu Murthy**<br>Professor<br>Department of Commerce<br>University of Delhi | **Dr Jaswinder Singh**<br>Principal<br>SGTB Khalsa College<br>University of Delhi<br>Delhi-110007 | **Dr. R P Singh**<br>Associate Professor<br>SGTB Khalsa College<br>University of Delhi | **Dr Vimal Rarh**<br>Deputy Director, Centre for e-Learning<br>and Assistant Professor,<br>Department of Chemistry, SGTB Khalsa College, University of Delhi<br>*Specialised in : e-Learning and Educational Technologies* |
| **Paper Coordinator** | **Content Writer** | | **Reviewer** |
| **Dr. Anil Kumar**<br>Associate Professor<br>Shri Ram college of Commerce<br>University of Delhi | **Dr. Anil Kumar**<br>Associate Professor<br>Shri Ram college of Commerce<br>University of Delhi | | **Dr Shirin Rathore**<br>Retired Professor<br>University of Delhi |
| **Anchor Institute : SGTB Khalsa College, University of Delhi** | | | |

## TABLE OF CONTENTS

1. Learning Outcomes
2. Introduction
3.Features of Company
4.Lifting of Corporate Veil
    4.1 Under Judicial Interpretation
    4.2 Under Express Statutory Provision
5. Summary

## 1. Learning Outcomes

After studying this module, you shall be able to

- Know the various features of the company
- Learn the doctrine of corporate veil
- Identify the cases when corporate veil of a company may be lifted

## 2. Introduction

Company is an incorporated association of persons created by law to pursue the expressly laid down objects. Chief Justice Marshal of U.S.A. has defined a company as

> "a person, artificial, invisible, intangible and existing only in the eyes of the law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

## 3. FEATURES OF COMPANY

Following are the broad features of a company:

### 3.1 Incorporated Association

Company is an incorporated association of persons created by the law of the country. In India companies are formed and registered under the Companies Act 2013, previously under the Act of 1956. Incorporation of a company requires registration of formal documents with the Registrar of Companies. Memorandum of Association is the important document which contains the fundamental conditions and purposes for which a company is formed. In fact, a company does not have its existence beyond its memorandum of association. The other important document is the Articles of Association which lay down the rules and regulations for governance of the company.

The 'Registration Certificate' or the 'Certificate of Incorporation grants a legal entity to a company enabling it to discharge functions such as entering into contract, purchasing, owning and holding of properties. A company may be held liable for breach of law. It can sue and be sued in its name.

### 3.2 Independent Legal Entity

A company has a legal entity distinct and separate from its constituent members (shareholders). It is an autonomous body, self-controlling and self-governing. It can hold and deal with any type of property of which it is the owner, in any way it likes. It can enter into contracts, open a bank account in its own name, sue and be sued by its members as well as outsiders. The rights and obligations of a company are distinct from its constituent members. "Shareholders are not, in the eyes of the law, part owners of the undertaking. The undertaking is something different from the totality of the shareholders." Shareholders cannot be held liable for the wrongs or misdeeds of the company.

A company has a nationality, domicile and residence but cannot ask for the enforcement of those fundamental rights which are exclusively available to national citizens. The nationality of the company, however, does not depend upon the nationality of its

shareholders. A company can enter into partnership with one or more individuals or another company. It can buy shares or debentures of another company. A company can form other companies by subscribing to their Memorandum of Association.
A director of a company can be the office bearer of the trade union of the workers of the same company. A shareholder, if qualified as a chartered accountant, can be the auditor of the same company. A director or a managing director cannot be held personality liable for the payment of arrears of taxes or salaries of employees due by the company. A company can sue for libel or slander effecting its business reputation.

A company can be held liable for criminal acts. It can be held liable for breach of law and can be made to pay fine. However, no imprisonment of a company is possible. It can be charged with conspiracy to defraud or may be convicted of making use of false documents with intent to deceive. It can also be held liable for torts committed by its employees in the course of their employment.
On account of this independent corporate existence the creditors of a company are creditors of the company alone and their remedy lies against the company and its property only and not against any of its members. Law recognizes the existence of the company quite irrespective of the motives, intentions, scheme or conduct of the individual shareholders.

The principle of separate legal entity of the company was judicially recognized by the House of Lords in 1867 in the case of ***Oakes* v.*Turquand and Hording (1867)***. It was then held that since an incorporated company has a legal personality distinct from that of its members, a creditor of such a company has remedy only against the company and not against an individual shareholder. Thus, a creditor of an incorporated company has remedy only against the company for his debts and not any of the members of whom it is composed. The position was further clarified by the House of Lords in the famous case of ***Salomon* v. *Salomon & Co. Ltd***.*(1897)* The facts of the case are as follows:
Mr. Salomon was the owner of a very prosperous shoe business. He floated a company 'Salomon & Co. Ltd.' with only seven shareholders, himself, his wife, daughter and four sons. The newly formed company purchased the sole proprietorship business of Mr. Salomon for £40,000. The purchase consideration was paid by the company by allotment of £20,000 shares and £ 10,000 debentures and the balance in cash to Mr. Salomon. The debentures carried a floating charge on the assets of the company.
The company went into liquidation within a year due to trade depression. On winding up, assets of the company were running short of its liabilities by £11,000. The unsecured creditors of the company contended that the company, though incorporated under the Act, had never an independent existence; it was in fact Salomon under the name of a company. On this ground, the creditors claimed priority for the payment of their debts over the debenture-holders (Mr. Salomon). Debentures had a floating charge on the assets of the company.
The plea of the unsecured creditors that Mr. Salomon and Salomon & Co. are one and the same was not accepted by the court. It was held that the existence of a company is quite independent and distinct from its members. Shareholders may also be the creditors of the company. Court recognized the separate and independent personality of the company.

"The company is at law a different person altogether from the subscribers to the memorandum, and though it may be that after incorporation the business is precisely the same as before, the same persons are managers, and the same hands receive the profits, the company is not in law their agent or trustee. There is nothing in the Act requiring that the subscribers to the Memorandum should be independent for unconnected, or that they or any of them should take a substantial interest in the undertaking, or that they should have a mind or will of their own, or that there should be anything like a balance of power in the constitution of the company."

The concept of separate corporate entity was again confirmed in the case of ***Lee* v. *Lee's Air Farming Ltd***.*(1961)* In this case Lee formed a company for the purpose of carrying on his own business of aerial top-dressing. He was the beneficial owner of the shares and also the sole "governing director" of the company. He also got himself appointed as the chief pilot of the company and under statutory obligations caused the company to insure him against liability to pay compensation under the Workmen's compensation Act. He was killed in a flying accident. In a suit by his widow for compensation, the Privy Council held that Lee and his company were distinct legal entities which had entered into contractual relationships under which he became, *qua* chief pilot, a servant of the company. In his capacity of governing director, he could, on behalf of the company, give himself orders, in his other capacity of pilot, and hence the relationship between himself as pilot, and the company was that of a servant and master. In effect the magic of corporate personality enabled him to be a master and servant at the same time and to get all the advantages of both—and of limited liability.[1]

The liability of an individual member is not increased by the fact that the sole person beneficially interest in the property of the corporation and that the other members have become members merely for the purpose of enabling the corporation to become incorporated and posses only a nominal interest in its property or hold it in trust for him.

The concept of independent corporate entity may under certain circumstances be disregarded.

### 3.3 Separate Property

The corporate property is clearly distinguished from the members' property and members have no direct proprietary rights to the company's property but merely their 'shares'. Change in the constitution of the company's membership will not cause any realization or slitting of its property. Company cannot be the property of the person who owns all the shares in the company, nor can it be considered to be his agent. No member can either individually or jointly claim any ownership rights in the assets of company during its existence or on its winding up.

"No shareholder has any right to any item of property owned by the company, for he has no legal or equitable interests therein." A member cannot have any insurable interest in the property of the company. The leading case is:

**Macaura v. Northern Assurance Co. Ltd. (1925)-**Mr. Macaura was the holder of nearly all the shares, except one, of a timber company. He was also the substantial creditor. He insured the company's timber in his own name. The timber was destroyed by fire. It was

[1]. Gower, L.C.B., "The Principles of Modern Company Law", Third Ed, p. 202.

held that the insurance company was not liable to compensate as Macaura had no insurable interest in the property which belonged to the company only.

### 3.4 Perpetual Existence

A company has a *perpetual succession.* It has no allotted span of life. The mode of incorporation and dissolution of a company and the right of the members to transfer shares freely guarantee the continuity of the existence of the company quite independent of the life of the members. The existence of a company can be terminated only by law. Being an artificial person it cannot die irrespective of the fact that its members, even the founders or subscribers to the Memorandum, may die or go out of it. Moreover, in spite of the changes in the membership of the company, it can perform its contracts and enter into future agreements. Thus, members may come and go but the company can go on forever.

### 3.5 Common Seal

Though a company has an artificial personality, it acts through human beings, who are called as directors. They act as agents to the company but not to its members. All the acts of the company are authorized by its “common seal”. The “common seal” is the official signature of the company. A document not bearing the common seal of the company will not be binding on the company.

### 3.6 Separation of Ownership and Management

A company is owned (de facto) by a number of shareholders which is too large a body to manage the affairs of the company. Shareholders set the objectives of the company and appoint their representatives or agents (known as directors) to manage the affairs of the company on their behalf to pursue their objectives. The directors, in turn, hire professional managers (executives) to run the day-to-day operations of the company under their supervision and control. This striking feature of separation of ownership and management has raised many issues which give rise to evolution of corporate governance as the focal point of modern corporations.

### 3.7 Limited Liability

The liability of shareholders of a company is different from the liability of the company. Shareholders generally[2] have limited liability- limited to the extent of unpaid value of shares held up. Shareholders have no obligation to the company once they have paid full amount on the shares held by them. In cases of losses, shareholders are not called upon to make good the losses[3]. Creditors cannot claim from the personal wealth of the

[2] Company law of many countries including India also provides for a company with unlimited liability, but such companies are very few and are in the nature of non-trading companies (pursuing religious or socially useful objects)

[3] There are a few exceptions when the shareholders or officers of a company may be called upon to compensate the company for the losses suffered by the company; or in cases of the officers including

shareholders. In the case of a guarantee company, the members are liable to contribute a specified agreed sum to the assets of the company in the event of the company being wound up.

### 3.8 Transferability of Shares

One can sell one's share of ownership rights to an interested buyer as the shares of a company are transferable. While in case of public companies shares are freely transferable which is provided by the law, there are some restrictions in the transferability of shares of private companies. In fact transferability of shares and limited liability are the enabling factors for the tremendous rise of companies all over the world.

## 4. Lifting up of the Corporate Veil

Though a company is a person created by law (*legal persona*) and it has a distinct entity, yet in reality it is an association of persons who are in fact the beneficial owners of all the corporate property. The persons behind a company are disregarded once they have formed a company and given to their association the status of a legal entity. There are, however, certain cases when this corporate veil of company will be probed into and lifted up.

The cases can be put under two categories:

(*i*) Cases falling under judicial interpretation.

(*ii*) Cases falling under express statutory provisions.

### 4.1 Under Judicial Interpretation

'When the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.'[4] Courts have in general disregarded the concept of independent corporate personality in those cases where corporate personality has been blatantly used as a cloak for fraud or improper conduct or doing things against public policy or for evading individual responsibility. Such cases can be put as follows:

#### ***4.1.1For determination of character of the company.***

In case it is suspected that the company is owned by the enemies of the country, the courts may in their discretion disregard the corporate veil and examine the character of persons in the real control of the corporate affairs. To allow alien enemies to trade under the corporate façade is against public policy. The leading case is:

---

directors are found to be negligent in discharging their duties. This is known as 'piercing the corporate veil'.

4. United State *v.* Milmaubee Refrigerator Transit co.

**Daimler co. Ltd.** ***v.*** **Continental Tyres and Rubber Co. (1916)** A company was incorporated in England to sell tyres manufactured by a German company. The German company held majority of the shares in the English company and all its directors were Germans. Thus the real control of the company was in German hands. During the World War I the company brought a case to recover a trade debt. The court was requested to restrain the company from doing so since it belonged to alien enemies.
The company was barred from maintaining the suit. It was observed that "a company is not a natural person with mind or conscience, it cannot be loyal or disloyal, it can be neither friend nor enemy, but it may assume an enemy character when person in *de facto* control of it affairs are residents in an enemy country or, wherever residents, are acting under the control of enemies."

### *4.1.2. For the benefit of Revenues.*

Courts may break brought the corporate shell of a company if it appears that the company has been formed for the only purpose of evasion of taxes or to circumvent tax obligation. Courts may refuse to identify the shareholders with the company when it is against the interest of the revenues of the government. The leading case is: **Sir Dinshaw Maneckjee Petit (1927)**

Sir Dinshaw Maneckjee Petit was a wealthy man enjoying huge dividend and interest income. He formed four private companies and agreed with each to hold a block of investment as an agent for it. Income received was credited in the accounts of the company but the company handed back the amount to him as a pretended loan. This way he divided his income into four parts in a bid to reduce his tax liability.
It was held that, "the company was formed by the assessee purely and simply as a means of avoiding super-tax and the company was nothing more than the assessee himself. It did no business, but was created simply as a legal entity to ostensibly receive the dividends and interests and to hand them over the assessee as pretended loans."

### *4.1.3. For preventing evasion of personal and statutory obligations.*

Courts may disregard the separate existence of a company where it appears that company was formed for evading contractual and statutory obligations. A case in point is:
**Gilford Motor Co. v Horne (1933)** Horne was appointed as the managing director of Gilford Motor Company on the condition that he would not solicit the customers of the company so long as he was the managing director of the company or afterwards. He attempted to evade this obligation by forming a company which undertook the soliciting.
It was held that the company started by Horne was a mere cloak or sham for the purpose of enabling him to commit a breach of his agreement against solicitation, and, therefore, it was restrained from enticing away Gilford Motor Company's customers.
Where a company is incorporated as a device or stratagem to conceal the identity of the proprietor of fraud, the corporate veil shall be lifted up. If an individual forms a company to avoid specific performance of his contracts, court will enforce specific performance against the company.

Further, court will not permit resorting to devise of incorporation of a company to evade welfare legislation. A case in point is:

**Workmen of Associated Rubber Industry Ltd. v. Associated Rubber Industry Ltd.** In this case, a company incorporated a subsidiary company and transferred to it some of its investments and securities only for the purpose of splitting the profits into two hands and thereby to reduce the incidence of the obligation to pay bonus.

The Supreme Court held that the separate existence of the new company would be disregarded for the purpose of working out the amount of bonus payable to workers.

### 4.2 Under Express Statutory Provisions

The Companies Act and other statutes provide expressly the circumstances where corporate veil of a company is disregarded. Following are some of those cases:

***4.2.2. Holding and Subsidiary Company Relationship.*** A company is termed as a holding company when it has the power to control the composition of the board of directors of another company or holds a majority of its share. The other company called a subsidiary of the former company has a separate legal entity. The principle of lifting the corporate veil is applicable in holding-subsidiary company relationship in two cases:
(i) Section 212 of the companies Act requires a holding company to attach to its Balance-Sheet, copies of the Balance Sheet, Profit & Loss Account, Director's Report and Auditors Report of each of its subsidiaries. Further, listed companies are required, as per the Accounting Standards, to prepare Consolidated Balance Sheet to give better information of the financial position of the group as a whole to the creditors, shareholders and public.
(ii) Where in spite of subsidiary companies being separate legal entities, the facts and circumstances show that they are in reality parts of one concern owned by a parent company or a group as a whole.

***4.2.3 Investigation in the affairs of a company.***

If an inspector is appointed under section 235 or 237 of the Companies Act to investigate the affairs of the company, he has the power to investigate also the affairs of any other related company in the same management or group (section 239). This is in complete disregard to the separate entities of the companies.

***4.2.4 Investigation of ownership of a company.***

Where it appears to the Central Government that there is good reason so to do, it may appoint one or more inspectors to investigate and report on the membership of any company and other matters relating to the company, for the purpose of determining the true persons -

( *a* ) who are or have been financially interested in the success or failure, whether real or apparent, of the company ; or
( *b* ) who are or have been able to control or materially to influence the policy of the company. (Section 247)
It, thus involves piercing the corporate veil.

### *4.2.5 Directors with unlimited liability.*

Ordinarily, the *liability of a director* in a limited company is the same as that of the members of the company. There is nothing in the Act, however, to prevent their liability being made unlimited by memorandum of the company or if limited by memorandum, being converted into an unlimited liability in pursuance of authority given by the articles. The same principle applies also in the case of a manager of a limited company. (*Sec. 322*)

### *4.2.6 Fraudulent conduct of business.*

If in the course of the winding up of a company, it appears that any business of the company has been carried on with the intention to *defraud creditors* of the company or any other persons, the Tribunal, on the application of the Official Liquidator or the liquidator or on application of any other creditor or contributory of the company may, if it thinks it proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in the manner above said, shall be personally responsible without any limitation of liability for all or any of the debts or other liabilities of the company as the court may direct. (*Sec. 339*)

***4.2.7 Failure to return Application Money.*** If the application money of those applicants whom no share has been allotted is not repaid up to the 45th day of the closure of the issue, then the directors of the company shall be jointly and severally liable to repay that money with interest @ 15% p.a. from the expiry of 45th day. [*Sec. 39*(*3*)]

***4.2.8 Misrepresentation in the Prospectus .***In the case of misrepresentation in a prospectus, every director, promoter and every other person who authorizes the issue of such a prospectus incurs liability towards those who subscribe for shares on the faith of untrue statements contained therein. Further, they may be held criminally also (Sec. 34).

***4.2.9 Mis-description of Name.*** Directors and other officers of the company will be personally liable for all the contracts made by them on behalf of the company in their personal names, *e.g.*,acceptance of a Bill of Exchange drawn upon a company by a director in his personal name or omitting to use the name of the company in the prescribed manner (for example, not using the word ‘Ltd.’ as a part of the company’s name). (*Sec. 147*)

### *4.2.10. Non-payment of Tax.*

When any private company is wound up and any tax assessed on the company whether before or in the course of or after liquidation in respect of any income of any previous year cannot be recovered, then every person who was a director of that company at any time during the relevant previous year shall be jointly and severally liable for the payment of such tax. He may, however, be exempted from this liability in case he proves that the non-payment of tax was not due to any gross negligence, misfeasance or breach of duty on his part. (*Sec. 179 of the Income-tax Act*)

### *4.2.11. Liability of Promoters for pre-incorporation contracts.*

Promoters will be personally liable for all those pre-incorporation contracts which are not adopted by the company after incorporation.

***4.2.12. Ultra vires acts.***

The directors of the company will be personally liable for all those acts which they have done on behalf of the company, if they are:

(*i*) *ultra-vires* the company, or

(*ii*) *ultra-vires* the directors if the company does not adopt their acts.

***4.2.13. Liability under other Statutes.***

There are many other provisions of the company law where director(s) of a company are personally liable for the default in complying with those provisions. Some of these are: non-maintenance of proper books of accounts; default in holding of annual general meetings; default in filing the annual returns; default in paying dividends after declaration; false declaration of solvency; non-cooperation with the company auditors or with the liquidators (in the event of winding up of the company); non-compliance with the regulations of the Securities and Exchange Board of India (SEBI). Besides these, directors may be held liable under pollution laws, social security laws (eg. Minimum Wages Act, ESI, EPF, Gratuity), Competition Act, Foreign Exchange Management Act (FEMA), and taxation laws.

In all the above cases, the corporate veil shall be broken through and the company shall not be allowed to use its legal entity to give shelter to the fraudulent or otherwise guilty persons.

## 5. Summary

- **The company has various features like perpetual succession, common seal, independent legal entity, artificial person , incorporated Association, transferability of shares, limited liability, separation of ownership and management.**
- **The entity of a company is separate from its members.**
- **The separate entity of a company which is also called corporate veil is may be lifted under certain situations.**
- **The situations under which corporate veil may be lifted are classified under two categories: judicial interpretation and statutory provisions.**