

PIERCING THE CORPORATE VEIL TO IMPOSE CRIMINAL LIABILITY ON CORPORATIONS

ABSTRACT

A company is treated as a separate legal entity distinct from its promoters, directors, members, and employees. The legal fiction of separate legal personality is, however, often used as a veil by corporations to escape criminal liability. The present paper tries to identify legal issues surrounding fastening of criminal liability on corporates. It delves into the element of 'mens rea' and also the compelling circumstances when courts disregard the corporate form and pierce the corporate veil¹. The paper in its attempt to identify the legal standards and relevant considerations and for piercing the veil, picks up some of the most recent and notable cases, including the much debated Vodafone Case² to reflect upon what goes into judges' head when they choose to compromise one legal principle for another. The paper then proceeds to raise one of the most important aspects of imposing criminal liability on corporation, i.e. liability of a parent company for the criminal wrongs of its subsidiary, particularly, in the context of Bhopal Gas case.³ It highlights the key findings of the decision to answer whether a parent company should be held liable for wrongs of its subsidiary. The paper concludes with a brief summary of the findings and authors' own personal approach to the same.

Keywords: criminal liability, corporation, separate legal personality, limited liability, corporate veil, piercing, *mens rea*, alter ego, identification doctrine, sham, fraud, parent company, subsidiary company.

¹ Black's Law Dictionary defines corporate veil as, "[t]he legal assumption that the acts of a corporation are not the actions of its shareholders, so that the shareholders are exempt from liability for the corporation's actions."

² *Vodafone International Holdings B.V. v. Union of India & Anr.* [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012]

³ *Union of India v. Union Carbide Corp. Ltd* (M.P.H.C.) [Unreported]

Financial scandals like, *Satyam*, *Enron* and *WorldCom* have raised concerns regarding imposing criminal liability on corporates.⁴ OECD in its executive summary of a paper⁵, pointed out that – “while corporate vehicles play an essential role in the global economic system, these entities may, under certain conditions, be misused for illicit purposes, including money laundering, bribery/corruption, hiding and shielding assets from creditors, illicit tax practices, self-dealing/defrauding assets/diversion of assets, market fraud and circumvention of disclosure requirements, and other forms of illicit behaviour.”

LEGAL ISSUES SURROUNDING IMPOSITION OF CRIMINAL LIABILITY ON CORPORATES

Imposing criminal liability on corporations has always been a subject of wide legal debate among various scholars. There are plausible arguments from both the quarters. Scholars, who insist on imposing criminal liability on corporates, argue that companies conducting illegal activities should not be treated differently from individuals engaging in similar activities.⁶ On the other hand, the opposite side uses ‘*mens rea*’ as its main defence. They argue that, since a corporation cannot have *mens rea*, it should not be held criminally liable.⁷ Another major defence they use against holding corporations criminally liable is, a corporation’s separate legal personality and limited liability⁸ of its shareholders.

A company is treated as a separate legal entity distinct from its promoters, directors, members, and employees. The legal fiction of separate legal personality, though, well recognised by the courts, is not a sacrosanct legal principle in any jurisdiction. It is an implement of public policy and can be justified only when firmly grounded in the public good. Courts in India and several other jurisdiction have therefore, rightly assumed the power to identify certain compelling circumstances, when it can pierce the veil and disregard corporate form to impose criminal liability on the promoters, directors, members, or employees of the company. Although, we observe a greater tendency of the courts to adhere to the limited liability principle in general, the

⁴ While, Enron used shell companies to create purchases, WorldCom used bank loans to defraud its stakeholders.

⁵ Anonymous, “*Behind the Corporate Veil: Using Corporate Entities For Illicit Purposes*”, OECD REPORT ON THE MISUSE OF CORPORATE VEHICLES FOR ILLICIT PURPOSES (2001) at p.7 also available at <http://www.oecd.org/corporate/corporateaffairs/43703185.pdf>

⁶ Taslitz, Andrew E., “*The Expressive Fourth Amendment: Rethinking the Good Faith Exception to the Exclusionary Rule*”, 76 MISS. L.J. 483, 537-538 (2006)

⁷ Engle, Eric, “*Extraterritorial Corporate Criminal Liability: A Remedy for Human Rights Violations?*”, 20 ST. JOHN’S J. LEG. COMMENT. 287, 293-295 (2006)

⁸ The liability of the shareholders is restricted only to the extent of capital that they invested in the company.

courts have never been reluctant to pierce the veil whenever a company is found to be involved in any form of criminal or illicit activities.

As regards the element of *mens rea*, courts have widely used the ‘identification doctrine’ to fasten the liability on corporations. The doctrine is a legal fiction in which courts try to identify “the actions of the "directing mind" of the corporation and merges individual and corporate persons in order to assign criminal liability to the latter.”⁹ With the most recent cases of *Vodafone International Holdings*¹⁰ and *Ram Saroop Gupta v. Major Sp Marwah*,¹¹ the principle still holds the ground to find the true identity of the company.

Thus we observe that lifting of corporate veil along with the identification doctrine, have emerged as key mechanisms for the courts to impose criminal liability on corporations even though a corporation *per se*, cannot have the *mens rea*.

LEGAL STANDARDS FOR PIERCING THE CORPORATE VEIL

The present standards for piercing the corporate veil, is still in its formative stage. Courts in India have, therefore, rightly given it the appellation of ‘changing concept, expanding its horizon’.¹² One key attribute of these standards is that they have always been very fact-specific. The fixing of liability differs only in degree, but not in kind.¹³ Therefore, it becomes very difficult to make sweeping generalizations about the standards courts can use to fix criminal liability on corporates. Despite that, judges have used their wide discretion in this regard to apply certain well accepted legal principles to impose criminal liability on corporates.

Conventionally, most piercing cases in the past relied upon the alter ego theory. The origin of this theory can be traced back to the Texas Supreme Court’s description of veil piercing in the following words - “under the alter ego theory, courts disregard the corporate entity when there exists such unity between the corporation and individual that the corporation ceases to be

⁹ Department of Justice, Canada, Discussion Paper on Corporate Criminal Liability (2002), available at <http://www.justice.gc.ca/eng/dept-min/pub/jhr-jdp/dp-dt/iss-ques.html>

¹⁰ Supra note 2

¹¹ RC.REV. 179 OF 2011, dated 4 May, 2012

¹² *State of U.P. v. Renuagar Power Co.*, (1998) 4 SCC 59; *Kapila Hingorani v. State of Bihar III* (2003) SLT 673

¹³ Bainbridge, Stephen M., “Abolishing Veil Piercing”, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236967

separate and when holding only the corporation liable would promote injustice.”¹⁴ What the courts exactly look into in such cases is, the actual dealings and close nexus between the shareholder and the corporation.¹⁵ The other indicator often used by the courts is “Sham to Perpetrate a Fraud.”¹⁶ One of the earliest cases which recognised this as a ground for piercing the corporate veil was *Castleberry v. Branscum*.¹⁷ The Court had observed that the veil can be pierced if “recognizing the separate corporate existence would bring about an inequitable result.” In such cases, what the courts actually look into is constructive fraud.¹⁸ Another important principle is the single business enterprise theory which, allows a claimant to trace the assets of one or more affiliates of a company, to satisfy the liability of the corporation on the basis that, the corporation and its affiliates “integrated their assets to achieve a common business purpose.”¹⁹ Here, the prime consideration is, whether or not two corporations in question operated as a single business enterprise to commit the default.²⁰

To sum up, the veil can be pierced in all cases depending upon factors like, relevant statutory or other provisions, object sought to be achieved, impugned conduct, involvement of public interest, and the interest of the affected parties.²¹

RELEVANT CASES WHEN THE VEIL WAS PIERCED TO IMPOSE CRIMINAL LIABILITY ON CORPORATES

Applying the principles mentioned above, courts in the past have pierced the corporate veil to tax underlying assets of a company in cases of fraud, sham, tax avoidance, etc. Earlier this year, the *Vodafone International Holdings v. Union of India*²², presented a case of misuse of the corporate structure to evade taxes. The apex court in this case observed that – “Once the transaction is shown to be fraudulent, sham, circuitous or a device designed to defeat the interests of the

¹⁴ *Mancorp, Inc. v. Culpepper*, 802 S.W.2d 226, 228 (Tex 1990), citing *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

¹⁵ *Id.*

¹⁶ Miller, Elizabeth S., “Owner Liability Protection and Piercing the Veil of Texas Business Entities”, at p.2 available at <<http://www.baylor.edu/content/services/document.php/117969.pdf>>

¹⁷ 721 S.W.2d 270 (1986)

¹⁸ Supra Note 16 at p.2

¹⁹ *Id.* at p.5

²⁰ *Id.*

²¹ Chauhan, Madhvender, “Corporate Personality & Piercing of the Corporate Veil”, available at <<http://jurisonline.in/?p=6237>>

²² Supra Note 2

shareholders, investors, parties to the contract and also for tax evasion, the Court can always lift the corporate veil and examine the substance of the transaction.”²³ The Court, in this case, accordingly held that the Income Tax Office was entitled to pierce the corporate veil in India to see whether or not a company was a resident of Mauritius and if it was paying income tax in Mauritius or not.²⁴ *Commissioner of Income Tax v. Sri Meenakshi Mills Ltd., Madurai*,²⁵ is another case in which the Court observed that the veil can be lifted to look into the economic realities behind the legal facade. Similarly, in *Life Insurance Corporation of India v. Escorts Limited and Others*²⁶, the Court pointed out four key instances when the veil can be pierced²⁷ –

- (a) where a statute itself contemplates lifting of the veil;
- (b) where there is a fraud or improper conduct intended to be prevented;
- (c) where a taxing statute or a beneficial statute is sought to be evaded, or
- (d) where associated companies are inextricably as to be, in reality part of one concern.

In India, Section 542 of The Companies Act, 1960 presents viable scope for piercing the veil to impose criminal liability for any kind of fraudulent conduct of business making the defaulter personally liable for the wrong, without any limitation of liability. The Court in one of the oldest cases, *Shri Ambica Mills Ltd., Re*,²⁸ pointed out that in cases of criminal acts of fraud by officers of a company, the court can pierce the veil to reach the substance of the matter. Another important case which came up this year is *VTB Capital v. Nutritek*²⁹ in which dispute arose out of a fraudulently obtained loan. The Court of Appeal, in this case made two important observations. First, it said - “lifting the corporate veil” does not ignore the existence of the company, but allows the court to provide a remedy that would otherwise be available only against the company (as opposed to the controller or vice versa).³⁰ Secondly, it said that there is no requirement that the corporate veil can be lifted only when there is no other remedy available.³¹ These two key points, when applied to a criminal case of default by companies, means that imposing criminal

²³ Supra Note 2 at para 75

²⁴ *Id.* at para 94

²⁵ AIR 1967 SC 819

²⁶ (1986) 1 SCC 264

²⁷ See also *Vodafone Case*, Supra Note 2

²⁸ 1897 AC 22

²⁹ [2012] EWCA Civ 808

³⁰ Niranjan V., “*VTB Capital: The Consequences of Lifting the Corporate Veil*”, available at <<http://indiakorplaw.blogspot.in/2012/09/vtb-capital-consequences-of-lifting.html>>

³¹ *Id.*

liability can very well be a remedy even when there are other remedies available. This is significant development because, it allows piercing of corporate veil to impose criminal liability even when the matter can be disposed by mere imposition of civil or administrative liability.

Thus, we observe that courts have exercised very wide discretion to decide whether or not to pierce the veil in a particular case to impose criminal liability. Being mindful of the fact that the primary goal of corporate law ought to be certainty and predictability,³² this has led to uncertainty and lack of predictability regarding legal standards for lifting of the veil. The judges can choose any theory of their choice or sometimes even invent a theory of their own to fasten the liability on corporates on equitable grounds. Therefore, we observe that although courts have time and again made references to the theory of group companies, shell company, alter ego and other similar legal principles, they have often used them without much clarity or decisiveness.

CRIMINAL ACTS BY SUBSIDIARY OF A COMPANY: THE BLAME GAME

Another most important legal issue related to fixing of criminal liability on corporations is whether a parent company or its subsidiary should eventually be held liable for the wrongful acts of the subsidiary. If it is said that the parent corporation cannot be held liable for criminal acts of the subsidiary, this can further encourage corporate irresponsibility. Companies can maintain strategic control from afar but strategically leave operations and safety mandates in the hands of local managers and the host government. This way, control can be maintained, while liability is evaded.³³

As a general principle, a parent corporation is not liable for the acts of its subsidiary. The report of the Committee³⁴ on International Investment and Multinational Enterprises (CIME) had pointed out that a liability on a parent company for criminal acts done by a subsidiary was not recognized even in the member states of the OECD.³⁵ Also, 'Corporate Veil' as a principle has so far, not been applied in situations of extraordinary environmental hazard caused by subsidiary

³² See, e.g., *Harff v. Kerkorian*, 324 A.2d 215, 200 (Del. Ch. 1974)

³³ Cassels, Jamie, "*The Uncertain Promise of Law: Lessons From Bhopal*", 29 OSGOODE HALL L. J. 1 1991 at p.20

³⁴ OECD had created this Committee for review and improvement of the OECD Guidelines.

³⁵ Therefore, it is the widely accepted practice in the member states of the OECD "not to 'pierce the corporate veil' unless special conditions justify such an extraordinary step; *Responsibility of Parent Companies for their Subsidiaries*, OECD Publications, 1980; See also Cohn and Simitis, "*Lifting the Veil in the Company Laws of the European Continent*", 12 ICLQ 189 (1963)

of a parent company.³⁶ Furthermore, the Indian Courts have also construed statute as "cracking open the corporate shell" only when constrained to do so by the clear mandates of the statute. In fact, they have taken extra precaution to avoid such construction wherever possible...³⁷ However, U.S. Supreme Court in *United States v. Bestfoods*³⁸ has pointed out that the Court can pierce the corporate veil to hold the parent company liable for the conduct of its subsidiary, if the corporate form is abused to achieve wrongful purposes, most notably, fraud on the shareholder's behalf and the parent company is directly a participant in the wrong complained of.³⁹

In India, the Bhopal Gas, case is one of the most suitable examples where the question arose as to whether parent company or the subsidiary is liable for the environmental hazard. The two legal issues involved in the Bhopal case⁴⁰ were- whether there is a direct duty of a parent corporation to manage its subsidiaries in a competent manner and, secondly, whether the parent corporation can vicariously be held liable for the acts of its subsidiaries.

The answer to the legal issues involved here lies in the fact that 'persons harmed by criminal acts of a multinationals corporation are not in a position to isolate which unit of the enterprise caused the harm, yet it is evident that the multinational enterprise that caused the harm is liable for such harm.'⁴¹ Holding the parent company liable is an effective measure to ensure full compensation to the victims of the criminal wrong and to make such corporations responsible. Justice Seth in the Bhopal case⁴² also pointed out that the veil can be pierced even solely on the equitable considerations, when faced with situations of mass disaster and assets of the subsidiary being grossly deficient to satisfy the just claims of the victims.⁴³ He further observed that the principle that a company has a legal and separate identity of its own is not an absolute principle and has much been watered down with the increasing number of exceptions since *Salomon v. Salomon*...⁴⁴.

³⁶ Kolvenbach Walter, "European Reflections on Bhopal and the Consequences for Transnational Corporations", 14 INT'L BUS. LAW. 357 1986

³⁷ Even looking from the American perspective the judiciary must have compelling reasons to ignore the limited liability rule in order to impose liability on shareholders; Ramaiya, A., GUIDE TO THE CORPORATE ACT (8th edn, 1977), at p. 108.

³⁸ 524 US 51 (1998) also available at <<http://www.law.cornell.edu/supct/html/97-454.ZO.html>>

³⁹ *Id.* at part III

⁴⁰ *Supra* Note 3

⁴¹ *Supra* Note 38, part III

⁴² *Supra* Note 3

⁴³ *Id.* at p. 88-91

⁴⁴ [1897] AC 22; *Supra* Note 3 at para. 14.02.02 [emphasis added].

CONCLUSION

The researcher observes that imposing criminal liability on corporates involve several legal issues, most notably, *mens rea*, separate legal personality, limited liability, piercing the corporate veil, liability of a parent company for the acts of subsidiary company. Courts in India and several other jurisdictions have time and again relied upon certain legal principles like, alter ego, sham to perpetrate a fraud, single business enterprise theory, identification doctrine, etc. to pierce the corporate veil and identify the 'directing mind' to impose criminal liability on corporations. These principles along with relevant case laws have helped the courts to fasten criminal liability on corporations. The relevant case laws also point towards the fact that imposing criminal liability can be an effective remedy even when there are other remedies available.

As regards the liability of the parent company for the criminal acts of its subsidiary, the author is of the opinion that holding the parent company liable is an effective measure to ensure full compensation to the victims and make such corporations responsible. If it is said that the parent corporation cannot be held liable for criminal acts of the subsidiary, this can further encourage corporate irresponsibility. Companies can maintain strategic control from afar but strategically leave operations and safety mandates in the hands of local managers and the host government. This way, control can be maintained, while liability is evaded.⁴⁵

To sum up, the veil can be pierced in all cases including criminal cases, depending upon factors like, relevant statutory or other provisions, object sought to be achieved, impugned conduct, involvement of public interest, and the interest of the affected parties.⁴⁶

However, as noted by the author, the concept of piercing the veil, though being commonly used, is still in its formative stage and expanding its horizon. The present legal standards regarding piercing the veil has given very wide discretion to the judges to decide upon whether or not to pierce the veil to hold company criminally liable. This has led to considerable uncertainty and lack of predictability regarding relevant considerations for lifting the veil. The uncertainty regarding the criteria for piercing the veil can be summarised in the following words -

⁴⁵ Supra Note 33

⁴⁶ Supra Note 21

“King Solomon ended up not splitting the baby when he understood who the real parent of the child was. Almost three thousand years after King Solomon, the judges and arbitrators might be fully aware of the real parent of the company, but it is very difficult to predict whether they would split the rights and liabilities, or treat the group of companies as one entity.”⁴⁷

⁴⁷ Kryvoi, Dr. Yaraslau, “Piercing the Corporate Veil in International Arbitration”, Vol.1, GLOBAL BUSINESS LAW REVIEW, (2011) at p.170, also available at <<http://www.globalbusinesslawreview.org/wp-content/uploads/2011/05/KryvoiY.pdf>>

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