The Corporate Veil in a Construction Context

Barristers **Chris Bryden** and **Georgia Whiting**, **Chambers of Timothy Raggatt QC, 4 King's Bench Walk**, explain why limited liability - shielding directors of failed companies behind the corporate veil, while exposing others to suffering - is a necessary double sided coin.

KEY POINTS

- The concept of limited liability plays an important role in corporate life.
- But it shields director from the misery felt along the supply chain in the event of insolvency.
- Claims can sometimes be pursued however against directors.
- Case law suggests that true instances of piercing the corporate veil will be rare.
- Insolvency will usually mean that the supplier loses out, as a consequence of the greater good of limited liability from a macroeconomic perspective.

The concept of the corporate veil plays a significant role in the context of the construction industry; incorporated companies shielding directors and shareholders from personal liability provides a necessary safeguard for individuals in the construction chain, as well as causing misery to those affected when a contractor incorporated as a limited liability company is wound up without the available assets to pay those elsewhere in the chain.

This article therefore considers the important role that the concept of limited liability companies has in the construction industry as well as the (limited) way in which one can peep behind or truly pierce the corporate veil so as to allow claims against individuals otherwise shielded by the corporate veil.

There are two fundamental principles behind corporate personality; first, every company has its own legal personality entirely separate from that of its directors or shareholders, meaning that it can contract, sue and be sued in its own right, and second, in the case of limited liability companies, the liability of the shareholders in terms of the company's debts is limited to the value of their shareholdings.

Even before statutory limited liability was conferred upon registered companies, the courts had recognised that insurance providers could confer limited liability for their members by way of the inclusion within insurance contracts of a term that members were not liable for, or would be indemnified in respect of the extent of the unpaid portion of their shareholding. Thus, the early cases in respect of separate corporate personality and the limitations of liability of shareholders were in respect of insurance contracts, and the court historically took a robust approach when considering such liability. For example, Turner LJ in ***Re Athenaeum Life Assurance Society (1859) 44 E.R 1423*** stated as follows:

> 'I do not see my way to hold that the shareholders can be made liable upon this representation [by the company]… unless indeed that can be reached on the ground of fraud; and I do not think that upon the facts before us any such case of fraud can be maintained.'

The concept that 'fraud unravels everything' is one which has been seen repeated in cases involving corporate liability and provides a potential exception to limited liability protection, as well be seen below.

It was in 1897 when the House of Lords determined the seminal case in respect of corporate personality in the case of ***Salomon v A Salomon & Co Ltd [1897] AC 22***. Mr. Salomon was a businessman who incorporated his business pursuant to the *Companies Act 1862* and, in accordance with the requirements of the same, appointed seven shareholders, who happened to be members of his family. Mr. Salomon, however, remained the key controller of the company.

The company was struggling financially, and a loan was taken out secured by way of a floating charge, but the business ultimately failed and the company went into liquidation. The grantor of the loan subsequently sought to enforce their security. At the time when the legal claim was made, the company was indebted to unsecured debtors, and a claim was brought directly as against Mr. Salomon. The first instance Judge upheld the claim on the basis that Mr. Salomon was acting as an agent of the company, and that the company was entitled to an indemnity from the principal. The decision was upheld by the Court of Appeal on the basis that Mr. Salomon had abused the privilege of incorporation as the incorporation of the company was improper; the Companies Act only contemplated the incorporation of independent bona fire shareholders with the will and minds of their own, and not mere puppets, as they found his use of family members was.

However, the decision was overturned by the House of Lords, who held that the Companies Act had to be the sole guide in respect of incorporation. By law, the company was not an agent nor a trustee of the subscribers, and the subscribers were accordingly not liable for the debts of the company.

There are generally considered to be two limbs to the House of Lords Judgment. The first limb dealt with the the question of what amounts to the improper use of the corporate form. Salomon had perpetrated no fraud, and the scheme which was essentially to shield himself from future losses which may be incurred did not amount to an illegitimate exploitation of the legislation in question. It was therefore not appropriate for the court to interfere with the company's separate corporate personality.

The second limb concerned the question of whether the proper response to fraudulent abuse of the corporate form was to impose a concealment-agency/ trust relationship. The House of Lords objected to a concealment-agency scenario because an agency relationship could not arise out of control alone, even when there was a single individual entitled practically to the full profits, as this would make all closely controlled companies agents and because impropriety of fraud do not lead to the inference of an agency agreement.

Since the House of Lords decision in ***Salomon***, the courts have followed the separate entity principle which has formed the basis of company law. It was not for a number of years that the higher courts revisited the question of veil piercing, most notably in ***Gifford Motor Co Ltd v Horne [1933] Ch 935***.

Mr. Horne was employed by Gifford Motors and entered into a restraint of trade covenant. Upon leaving the employment of Gifford, Mr. Horne set up a separate company and caused the same to solicit customers which would have been in breach of the restraint covenant had it been undertaken by Mr. Horne himself. The Court of Appeal held that the business was a 'mere cloak or sham' intending the real owner to evade his pre-existing obligations meaning that the courts could simply disregard the legal ownership of the business. However, the Court did not define the precise manner in which a company was to be considered as a 'mere cloak or sham', and there has been much uncertainty from this point as to when such a situation will arise. As a consequence, the courts for a number of years sought to expand the ambit of veil piercing, and decisions included disregarding corporate personality in respect of corporate groups on the basis that they were operating as a single economic unit, and even on the grounds that it was necessary to do so in the interests of justice.

The tide turned with the case of ***Prest v Petrodel Resources Ltd [2013] UKSC 34, [2013] 2 AC 415***, in which the Supreme Court sought to move away from the vague terminology used in previously decided cases and define the concept of veil piercing more accurately.

Prest was in fact a satellite claim arising out of a family law case in which Mrs. Prest made an application for financial remedies (previously Ancillary Relief). The Supreme Court held that various estates in land which were registered in the names of companies controlled by Mr. Prest were assets to which Mrs. Prest was entitled to claim within the divorce proceedings pursuant to the *Matrimonial Causes Act 1973*. However, this was not on the basis of piercing the corporate veil at all; rather, it was on the basis that the companies held the land on resulting trust for Mr. Prest as he had provided the purchase monies and the companies had not participated in disclosure. As a result an inference was drawn against the companies and Mr. Prest. The ratio of the decision therefore had no bearing on the piercing of the corporate veil. However Lord Sumption did spend a significant part of the judgment considering the legal basis for the piercing of the veil.

Two key principles

Whilst his comments were obiter and there is debate about the correctness of his classifications, Lord Sumption considered that there were two key principles at work when one considered the issue. Firstly, the evasion principle, and secondly, the concealment principle. According to both Lord Sumption and Lord Neuberger the 'evasion principle' provides the sole justification for veil piercing, but can only be invoked when a company's controller has abused a corporate form by manipulating the company so as to facilitate the evasion of an existing liability.

All other instances of perceived abuse of the corporate form will fall within the 'concealment principle', which instead relies upon ordinary principles of law in order to establish liability.

It is clear from the decision in ***Prest*** that true instances of piercing the corporate veil will be rare. However, it also emphasises the need to think creatively, and the fact that the courts will look to alternative remedies in appropriate cases, such as the finding of a resulting trust in ***Prest*** itself, though the circumstances leading to that finding were perhaps unusual.

In addition to trust cases, practitioners should also be alive to instances in which a tortious act may have been committed. In particular, companies will be liable for torts committed by their agents or employees where they are committed during the ordinary course of business. Whilst a parent company will not be liable for its subsidiaries simply by virtue of owing 100% of the shares in the same, they may well owe a duty of care to the employees of its subsidiaries. This does not, however, truly involve the piercing of the corporate veil or the transferring of liability, rather, it is a free-standing duty of care owed by the parent company to the claimant as a result of the relationship between the parent and its subsidiary.

In the construction sphere, care must therefore be taken before seeking to impose liability upon directors or shareholders where the incorporated entity becomes insolvent. It is likely only in egregious circumstances involving the evasion of liability will such liability arise. In most circumstances the irrecoverability of money as an unsecured creditor in an insolvency situation will simply be the result of the well-established principle of limited liability, and for this reason suppliers in the chain will often wish to consider insurance to protect them from an insolvency or, where they have bargaining power, advanced payment or payment in escrow. Whilst there are other potential methods of recovery against directors (such as wrongful trading, dishonest assistance in a breach of trust or knowing receipt of trust monies) these are unlikely to arise in an ordinary construction insolvency. In most cases, an insolvency will mean that the supplier loses out; this is simply a consequence of the greater good of limited liability from a macroeconomic perspective. **CL**