

VEIL PIERCING - A NECESSARY EVIL?

A CRITICAL STUDY ON THE DOCTRINES OF LIMITED LIABILITY AND PIERCING THE CORPORATE VEIL

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1. Introduction

The company is equal in law to a natural person. This is one of the cornerstones of South African company law, and has been since 1897 when the House of Lords handed down its decision in *Salomon v Salomon and Co (the Salomon case)*.¹ An important principle flowing from the *Salomon* case is that a company has its own legal personality, one which is distinct from its members. It allows a company to perform juristic acts in its own name, as well as to sue and to be sued. Further, members and directors enjoy protection against personal liability.

Although this fundamental rule has a considerable influence in company law worldwide (including South Africa), it cannot be absolute and, as such, must allow for exceptions (where the courts may disregard the separate legal personality of the company).² This paper will focus on the limited liability of the company and one of the important exceptions to this rule: piercing the corporate veil.

This paper reveals, after a detailed analysis, that the doctrine of piercing the corporate veil is inherently flawed. While accepting the necessity for such a doctrine in the context of a global market, this paper shows that its application in many jurisdictions, including South Africa, has proved to be problematic. The question that arises for consideration is whether the difficulties associated with piercing the corporate veil outweigh the obvious benefits of its existence. Put another way, does the doctrine, with all of its flaws, bring about sufficient benefits to justify its maintenance within the South African legal system, or are there in fact other remedies to assist those seeking to hold directors and members liable for the conduct of the company? This paper addresses these issues, and ultimately seeks to assess the prospects of the doctrine in respect of its permanence within the South African legal system.

This paper begins with an examination of the doctrine of limited liability, its historic origins, the role it plays in international company law, and its various benefits. In light of the fact that veil piercing erodes the limited liability of a company, it is necessary to appreciate both the relevance and the significance of limited liability. If it can be argued that limited liability has little importance in a legal system, then courts would be justified in disregarding the notion in cases where fairness and equity are at stake. If, however, the role of limited liability

¹ *Salomon v Salomon and Co Ltd* [1897] AC 22 (HL).

² EJ Cohn and C Simitis, "Lifting the Veil" *In the Company Laws of the European Continent*, *The International and Comparative Law Quarterly*, V 12 1963 189 at 189.

proves to be relevant, then courts would be justified in piercing the veil only in exceptional circumstances, if at all.

Part 2 discusses the doctrine of veil piercing from a critical perspective. An oft-cited criticism of the doctrine is that it comes with no clear guidelines directing courts to the appropriate circumstances for piercing the corporate veil. This section of the paper illustrates the various approaches that courts have taken in deciding whether or not to pierce the corporate veil. This discussion includes a critique of what is referred to as the “categorisation approach”, as well as other tests that have been applied in South African and abroad. Much of this section is buttressed by extensive case analyses, which is followed by a detailed look at both the advantages and disadvantages of the veil piercing doctrine.

This paper will ultimately highlight the need for reform in respect of the doctrine of separate legal personality and, accordingly, will consider viable alternatives to this doctrine. Such alternatives include how the courts could avoid invoking the veil piercing doctrine whilst still being able to grant plaintiffs’ relief, examining whether the legislature should legislate this area of law and, if so, how this should be done. In addition, this paper will examine other theories to assist the courts with avoiding the use of the veil piercing doctrine such as Larkin's³ ‘entity theory’.

2. **Part 1 - Limited liability**

2.1 **What is limited liability?**

The basic principle of limited liability is that the company has a legal personality separate and distinct from its members’. Each can own their own assets and incur their own liabilities. Flowing from separate legal personality is the more important notion of limited liability. The company laws in jurisdictions with advanced economies allow for companies to carry on their businesses with limited liability. Accordingly, the most a member in the company can lose is the amount paid for the shares themselves and thus the value of his/her investment⁴. As such, creditors who have claims against the company may look only to the corporate assets for the satisfaction of their claims as creditors and generally cannot proceed against the

³ MP Larkin ‘*Regarding judicial disregarding of the companies separate identity*’ SA Mercantile Law Journal V1 1989/90 277.

⁴ Prof N Hawke, *Corporate Liability*, London Sweet and Maxwell 2000 p108.

personal (separate) assets of the members. This has the effect of capping the investors' risk whilst, consequently, their potential for gain is unlimited.⁵

2.2 **The historic origins of the doctrine of limited liability**

At the start of the nineteenth century, unlimited liability was introduced in the United States of America through legislation. This legislation was based on the belief that, without unlimited liability placed upon the member, there would be insufficient security for the corporate creditor and that, without this security, it would be difficult to raise the necessary capital required to operate a business. In the 1840's, the prevailing view changed and the consequent amendment to the relevant legislation reflected the view that, in order to further the provision of capital, formalities should be created to allow for members to invest in companies whilst limiting their personal liabilities. Accordingly, the policy change limiting the personal liability of members encouraged the incorporation of companies, thereby stimulating economic growth.⁶

The timing of the policy change could not have been better – the industrial revolution was a time when businesses needed capital and required substantial investment. Accordingly, companies started looking to external sources for funding. The introduction of limited liability encouraged investors to fund companies through capital contributions as they could rest assured in the knowledge that their personal assets would not be at risk. The investment in the capital of a company allowed the investor to enjoy his/her share of the profits of the company without risking more than the capital invested (as opposed to loan funding, where the return was limited). It became evident that the development of the capital market depended on limited liability as, while people were willing to risk their net worth in a company which they operated, they were not willing to invest in a business over which they had little control and did not operate or monitor closely.⁷

2.3 **The development of limited liability in South Africa**

The modern company in South Africa has its roots in the company legislation of 1844 - 1862 as well as in the *Salomon* case. The Joint Stock Act of 1844 simplified the process of and reduced the costs of incorporation, allowing for the corporate

⁵ Gower and Davies *Principles of Modern Company Law* (7Ed) London Sweet and Maxwell (2003) at 176. If the company is successful and is not liquidated.

⁶ SB Presser, *Thwarting the killing of the Corporation: Limited Liability, Democracy and Economics*, 87 Nw. U. L. Rev. 148 at 155.

⁷ *Ibid* at 155.

form to be employed by a wider range of users.⁸ However, this Act made no provision for the limitation of members' personal liability.⁹

Although there was no express limited liability in the Act at this time, a trend emerged in practice whereby a form of *de facto* limited liability was being achieved through statements in all contracts entered into by companies (either by creating a form of an insurance clause or by stipulating that neither the directors nor the members could be held personally liable for the debts of the company).¹⁰

Limited liability was first given statutory recognition in the United Kingdom in the Limited Liability Act of 1855. This Act stipulated that certain requirements had to be met in order for members to enjoy limited liability. This Act was then incorporated into the 1856 Joint Stock Companies Act in South Africa. According to the Joint Stock Companies Act, once all registration formalities were achieved, there would be automatic limited liability.¹¹

2.4 Limited liability and the separate personality of the company

The concept of separate legal personality goes hand in hand with the doctrine of limited liability and, although separate personality was a consequence of the Joint Stock Companies Act of 1844, as discussed above, it took 53 years until the courts began addressing the implications of this separateness in detail.¹²

In *Foss v Harbottle*¹³, the court confirmed the idea that when a wrong is committed against a company, the company itself would be the plaintiff in the proceedings and not the members. This principle was later reinforced in the *Salomon* case¹⁴, where it was held that the company is a separate legal person, this being the first time the court asserted the separate legal existence of the company.

⁸ Cheong - Ann Png, *Corporate Liability, A Study in Principles of Attribution*, Kluwer Law International (2001) at 3.

⁹ M Glazer, *Piercing the Corporate Veil: A Review of the Concept; and Consideration of its Relevance in South Africa Tax Law*, Dissertation, The University of Cape Town, 1994 at 2.

¹⁰ M Glazer, *Piercing the Corporate Veil: A Review of the Concept; and Consideration of its Relevance in South Africa Tax Law*, Dissertation, The University of Cape Town, 1994 at 3. This is similar to present day insurance contracts. See below for more detail.

¹¹ *Ibid* at 3. It is important to note that the Companies Act, No. 61 of 1973 provides for two types of companies, a company with a share capital, which can be a public or a private company, where Limited and (Proprietary) Limited will follow the name of the company respectively and a company that does not have a share capital. A company without a share capital may be a company limited by guarantee and the words (Limited by Guarantee) follows the name of the company. Members' liability in companies limited by guarantee is limited by the memorandum to the amount to which the members undertake to contribute should the company be wound up. See sections 19, 40, 52(3) of the Companies Act. See Cilliers and Benade, *Corporate law*, 3 Ed, Lexis Nexis Butterworths 2004, para 3.09. This paper focuses on companies with share capitals and not on companies limited by guarantee.

¹² *Ibid* at 2. See *Supra* 1.

¹³ *Foss v Harbottle* (1843) 2 Hare 43; 67 E.R. 189.

¹⁴ *Supra* 1.

In terms of the *Salomon* case, members of a company would not automatically, in their personal capacity, be entitled to the benefits nor would they be liable for the responsibilities or the obligations of the company. It thus had the effect that members' rights and/or obligations were restricted to their share of the profits and capital invested.¹⁵ The court, per the dicta of Lord Halsburg, held, "*Once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and ... the motive of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.*"¹⁶ Lord Macnaghten stated that, "*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 it was before, and the same persons and managers, and the same hands receive the profits, the company is not in law the agent of the subscriber...*"¹⁷ However, the court made it clear that in the event of fraud or dishonesty being proven, the separate corporate personality must be discarded.¹⁸

President Butler of Columbia University has described limited liability as the greatest discovery of modern times.¹⁹ Notwithstanding this view, there are some commentators who argue that limited liability can be subject to abuse, as limited liability is capable of manipulation (as was recognised as far back as the *Salomon* case)²⁰. Accordingly, there are circumstances where courts will disregard the limited liability of the company, such as in instances of abuse and fraud or where the company was used as an agent of its owner.²¹ In these circumstances, the disregarding of limited liability will result in the members and/or the directors being personally liable for the debts and other obligations of the company.²²

The extent to which one believes that the courts should or should not pierce the corporate veil and impose personal liability upon members will depend upon one's assessment of the policy merits of limited liability. As a result, it is necessary to have a clear understanding of the arguments both for and against the doctrine of limited liability. On the one hand, if one is of the view that limited liability is unsound, one would then take a liberal view towards veil piercing whilst, on the other hand, if one is of the view that limited liability is a fundamental principle that

¹⁵ Supra 10 at 3.

¹⁶ Supra 1 at 30.

¹⁷ Supra 1 at 51.

¹⁸ Supra 10 at 3. This will be discussed in greater detail below.

¹⁹ S B Presser, *Piercing the Corporate Veil* s 1.01 at 1-5.

²⁰ This will be discussed in greater detail below.

²¹ CM Schmitthoff, *Salomon in the Shadow*, *The Journal of Business Law* 1976, 305 at 306.

should not be fettered, one would be more willing to restrict and limit the use of the doctrine of veil piercing.²³

2.5 The consequences and effects of limited liability

Limited liability can be said to protect the company and its members, as well as to facilitate commercial ventures in which the company may be interested.²⁴ Limited liability encourages and attracts corporate investment.²⁵ With this in mind, limited liability can raise management's standards. This can be done through an influence of corporate control which can result in greater transparency for corporate operations and can facilitate better investment strategies by the company.²⁶

2.5.1 Historical Perspective – Investors of Moderate Means

During the nineteenth century the importation of limited liability was designed to and served to encourage the small-scale entrepreneur. A popular view of the time was that, without limited liability, only the very rich were in a position to invest in companies. It was thus felt that if people of moderate means were disincentivised from investing, the economic process would be stifled.²⁷ In the United Kingdom, it was argued that limited liability would facilitate investment by middle and working class citizens, people who were otherwise discouraged from investing due to the high risk involved under an unlimited liability regime.²⁸ Limited liability allowed for the entry into the business market being competitive and democratic and thereby facilitated the growth of an urban democracy through widespread participation in business and the opportunity for all people to acquire wealth.²⁹

A further consequence of limited liability is its assistance in the promotion of commercial activity.³⁰ Limited liability facilitates investments from the public, people who are not professional investors, by encouraging the investment of

²² Supra 7 at 181.

²³ SM Bainbridge, *Abolishing Veil Piercing*, 26 J. Corp Journal of Corporate Law Spring 2001 479 at 487.

²⁴ Supra 6 at 117.

²⁵ Ibid at 117.

²⁶ F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (1991), Chap 2.

²⁷ Supra 8 at 155.

²⁸ Ibid at 155 quoted from, Halpern, Trebilock and Turnbull, *An Economic Analysis of Limited Liability in corporation Law* 30 U. Toronto, L.J. 117, 118 (1980).

²⁹ Ibid at 155. This argument is based on the popular democratic justification for limited liability. One must note that modern scholars rarely observe this.

³⁰ JH Matheson and RB Eby, *The Doctrine of piercing The Veil in an Era of Multiple Limited Liability Entities: An opportunity to Codify the Test For Waiving Owners' Limited-Liability Protection*, 75 Wash. L. Rev. 147 at 151.

surplus funds into large capital projects.³¹ As H G Manne said “[*Limited liability*]... allows individuals to use small fractions of their savings for various purposes, without risking a disastrous loss if any corporation in which they have invested becomes insolvent.”³²

Easterbrook and Fischel argue that limited liability will allow for a diversification of members, thereby lowering the risk of losing one’s investment, lowering the cost to members and allowing companies to raise capital. Little or no diversification would result in a company having a diminished ability to raise capital as the cost of investment would rise and correspondingly the demand for such investment would decrease.³³

2.5.2 **Monitoring Investments**

Connected to the argument of diversification is the argument of monitoring. Monitoring investments is expensive and investors generally have full time jobs which are unrelated to the investment.³⁴ As a result many investors would rather not invest in an enterprise for fear of losing their entire wealth in an investment over which they have no control. Limited liability allows investors to diversify their investments, as the risk of each investment failing does not extend to the investor’s entire wealth. As such, there is less of a need to monitor and scrutinise all of their portfolios.³⁵

2.5.3 **Monitoring Members**

Personal liability would result in creditors relying on members to be responsible for the debts of the company.³⁶ Creditors of companies would thus be required to continuously assess and monitor the creditworthiness of all the members, resulting in increased cost and burden on the creditor.³⁷ Not only would the creditors continuously monitor members but members would continuously monitor each other.³⁸ Easterbrook and Fischel argue that limited liability reduces the costs of monitoring other members. If there was a regime of unlimited liability then any one member could be responsible for the

³¹ Supra 7 at 177.

³² HG Manne *Our Two corporation Systems: Law and Economics*, 53 Va. L. Rev. 259 (1967) at 262.

³³ Supra 28 at 43.

³⁴ Supra 25 at 490-491.

³⁵ Supra 32 at 156.

³⁶ This is provided that the members are not jointly and severally liable.

³⁷ Supra 25 at 493.

³⁸ Supra 28 at 41.

entire debt of the company. To prevent this from happening one would need to be sure that all members have sufficient wealth to bear their potential share of the debt if the company is unable to satisfy it. Even if members are satisfied that their co-members are able to meet their share of the company's debt at a particular point in time, they would be required to ensure that this remains the case by continuing with their monitoring of one another, to ensure that they do not transfer their assets or sell their shares to others who have less wealth than themselves.³⁹

Monitoring expenses could be easily limited simply by the legislator introducing legislation that imposes separate liability or liability on individual members in proportion to their investment in the company.⁴⁰ Either option will reduce the need for creditors and other members to monitor the members of the company, resulting in members' wealth becoming irrelevant⁴¹. Proportional shareholder liability is discussed in greater detail below.

Based on the argument that the investors would need to monitor all other members in the company in the event of the members being liable for the corporate debts, Easterbrook and Fischel argue that limited liability allows for the market to assimilate information efficiently to price shares as pricing can only be done on the basis of information about the firm's prospects.⁴² With unlimited liability, the task of pricing shares will be a difficult task resulting in shares becoming less tradable.⁴³ Halpern, Trebilock and Turnbull, argue that limited liability facilitates the trading of shares at a uniform price.⁴⁴ Limited liability facilitates the operation of public securities markets⁴⁵ as the investor does not have to concern himself with the wealth of his fellow investor.

Others argue that there is no basis for the above argument, as the need to monitor other members will disappear under a regime of proportional shareholder liability.⁴⁶ The decrease in the need of creditors and members to

³⁹ Supra 28 at 42.

⁴⁰ Supra 8 at 160.

⁴¹ Supra 8 at 161.

⁴² Ibid at 161.

⁴³ Ibid at 161.

⁴⁴ Supra 8 at 177. The problem with the arguments above, being in favour of limited liability, is that it is not persuasive for companies which have not, nor plan to go public.

⁴⁵ Ibid at 177 referenced from, Halpern, Trebilock and Turnbull, *An Economic Analysis of Limited Liability* (1980) 30 University of Toronto L.J. 117.

⁴⁶ Supra 8 at 161.

monitor members of the company, decreases risk which in turn allows for passive investments and reduces the cost of operating the company.⁴⁷

This argument may, however, be flawed as it ignores the origins and the continued maintenance of the limited liability doctrine. If investors and creditors were in fact forced to monitor members under a regime of unlimited liability, the monitoring may well be done in a similar manner as it is done today, where brokers or management perform a monitoring function. Thus monitoring could be done at the time of the initial investment and thereafter. Accordingly, if the potential return on an investment is high, investors might still invest by choosing their initial investment with regard to a track record of monitoring abilities or proven successful business strategies of management, - the decisive factor for investing would remain the profit potential of the enterprise.⁴⁸

It is important to recognise, on this basis, that the leading criterion for investment is to make a profit. The same calculation is made under both a regime of unlimited liability and under limited liability. The important consideration is the quality of the investment opportunity itself, and not the elimination of possible personal liability when an investor decides to commit his or her capital.⁴⁹

Others argue that creditors are able to investigate the capitalisation of companies, and reduce risk where necessary by adjusting the reward (through an increased return). They can thus protect themselves against any increased risk that they might have assumed as a result of limited liability. Accordingly, it is argued that there is nothing inherently wrong with limited liability as creditors have other means of protecting themselves.⁵⁰

2.5.4

Externalising of Risk

A further advantage of limited liability is that it allows companies to externalise the risk involved with modern industrial enterprise and passes the

⁴⁷ Supra 28 at 42.

⁴⁸ Supra 8 at 159.

⁴⁹ Supra 8 at 159.

⁵⁰ Supra 8 at 157.

risk to the creditor.⁵¹ This is not, however, always the case. In circumstances where the creditors exert strong countervailing power against the company, creditors may be in a position to utilise this power to force the company to accept a limit on the extent to which it can externalise its risk. Where corporate financing is present (particularly where there is a scarcity of finance available to the company⁵²), there is a likelihood that there exists a strong presence of creditors in the market, which could result in the externalities not being passed outside of the company

2.5.5 Excessive Corporate Risk

If a judgment is rendered against a company which is in excess of the company's ability to pay, limited liability results in the judgement creditor being unable to collect the residual amount from the company's members⁵³. This can result in companies taking excessive corporate risks and unfairly limiting the ability of the plaintiff with a valid claim.⁵⁴ This too has resulted in an argument for an alternative to the doctrine of limited liability.

However, limited liability may encourage investors, through companies, to invest in risky projects that render high returns, as they are immune from personal bankruptcy. If this were discouraged through unlimited liability, there may well be a social loss, as projects that might have high returns and beneficial uses of capital are risky and not pursued.⁵⁵ Accordingly, by encouraging the most beneficial uses of capital and more risky investments, society as a whole could benefit⁵⁶. This may result in an increase in social wealth.⁵⁷

2.5.6 Free Riding

Unlimited liability could result in free riding by members. Free riding could occur whenever it is necessary to take contributions from a group of individuals in order to carry out a collective goal or purpose of the company.⁵⁸ The argument is based on the idea that members (the free riders) will not

⁵¹ Supra 25 at 489. Henry Hansmann and Reiner Kraakman argue that limited liability gives corporations the ability to externalise tort risks, these risks can exceed the net worth of the corporation. Hansmann and Kraakman, *Towards Unlimited Liability for Corporate Torts* 100 Yale L.J. 1879 (1991).

⁵² Supra 6 at 117.

⁵³ J Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 Yale, L.J. 387(1992) 387-88

⁵⁴ Ibid at 388.

⁵⁵ Supra 28 at 44.

⁵⁶ Ibid at 44. These are investments where the potential gain is greater than the potential loss.

⁵⁷ Ibid at 44.

contribute as they are of the view that others would contribute sufficient resources to ensure that the goal in mind would be met, thereby receiving the benefits of the collective activity without having to expand any personal resources.⁵⁹

2.5.7 **Corporate Goal**

Originally, limited liability was introduced to protect members from the commercial risks that arose from the operation of a single company⁶⁰. However, with the advent of corporate groups came the question of whether the protective framework could be transported to the newer group-based structures for the benefit of the member companies.⁶¹

A problem that can arise under limited liability, with regard to corporate groups, is that each holding company of the multi-tiered corporate group is insulated from liability for unsatisfied debts of its subsidiary. In the multi-tiered group, there are thus as many layers of limited liability as there are tiers in the corporate structure. Limited liability for corporate groups accordingly opens the door to many layers of insulation. This is a consequence which was unforeseen when limited liability was adopted.⁶²

According to, Blumberg, the importation of limited liability to group structures undermines the very objective of the doctrine, as it overlooks that the parent and the subsidiary company are collectively carrying on a common enterprise. The business could thus be fragmented amongst the various components of the group, resulting in limited liability protecting each fragment from liability, and in this manner being protected from the obligations of the other fragments which in reality are part of the same business.⁶³

2.5.8 **Conclusion**

It is thus clear from the foregoing that limited liability is most certainly essential to any sound economy and the corporate legal principles governing

⁵⁸ Supra 25 at 491.

⁵⁹ Ibid at 491.

⁶⁰ Supra 6 at 118.

⁶¹ Supra 6 at 119.

⁶² Supra 6 at 139.

⁶³ P Blumberg, *The Multinational Challenge to Corporate Law*, Oxford University Press New York, 1993 p 139 at 159.

it. It is equally clear, however, that the doctrine of limited liability is not perfect.

The question thus remains as to whether the principle should be adhered to at all times, bearing in mind its importance, or whether it be relaxed in certain instances. In addition, it is necessary to consider whether or not there exist less invasive alternatives.

3. **Proportionate liability- an alternative to limited liability**

3.1 **What is proportionate liability?**

Although limited liability most certainly performs an important function, it is necessary to compare it with other theories. A popular alternative to limited liability is proportionate liability, which holds members proportionately liable for the claims that the corporate assets are insufficient to cover, *pro rata* to their equity interest in the company.⁶⁴

Under the doctrine of limited liability, if a judgment is ordered against a company, the judgment creditor is limited to recovering the amount owed to him/her from the company itself. The problem that may arise is if the company's liabilities exceed its assets, the company will be unable to pay its debts. In such a situation, the judgment creditor is unable to collect the remainder of the money owed to him from the members personally as his claim is against the company itself⁶⁵

Under the proportionate liability regime, if the company has insufficient assets to satisfy the judgement creditor's claim, the creditor is entitled to recover the amounts owed to him from each member equal to an amount proportionate to that member's equity interest in the company.⁶⁶ As such, the balance of protection afforded under the law would rest with the creditor.

⁶⁴ Supra 55 at 388.

⁶⁵ Supra 55 at 387-388.

⁶⁶ Supra 55 at 387-388. *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 Yale, L.J. 387(1992) 388. The example the author gives is that, if a corporation is found liable for \$1.2 Billion in delict damages, but has assets of only \$200 million, an owner of 1% of the shares would be liable for 1 percent of the residual \$1 billion. Whilst under limited liability the members are protected from any liability for damages which the corporation itself cannot cover.

3.2 The Effect of Proportionate Liability

It is argued that one of the possible effects of proportionate liability, especially if applied to large publicly listed companies, is the decline in share prices by an amount that reflects the perceived magnitude and probability of events, which could result in exposing members to claims that are in excess of the corporate assets.

Advocates of proportionate liability are of the view that this would incentivise corporate management to engage in activities that are less risky, as well as result in members purchasing 'portfolio insurance', which would protect them against this new financial exposure.⁶⁷ This would in turn result in a decision-making process that would internalise risk, which would manifest in higher, more preferable and responsible, standards of care. This consequence would result in a lower incidence of creditors' claims, in addition to which there would be equitable compensation to the creditor, as more assets would be available to satisfy claims, as claims would not be limited to corporate assets, but would also extend to the members for an amount proportionate to his equity interest.⁶⁸

It is, however, important to note that the above is a theoretical argument. Proportionate liability might not generate the benefits that are predicted above.⁶⁹

It is further argued that those who advocate for proportionate liability have not done a careful analysis of capital markets as is required. Grundfest states that the capital markets are extremely dynamic and may respond to proportionate liability by generating a large clientele of investors who are "*de facto* attachment-proof in actions seeking recovery of proportionate damages."⁷⁰ These investors can specialise in holding equity which is susceptible to third party claims, under a proportionate liability regime, whilst attachable members might hold equity that is unlikely to generate proportionate liability exposure. This could result in transactions in the future, options or swap markets being able to reallocate equity market risk without shifting the proportionate liability exposure, thus leaving share prices unchanged from prices that would exist under a limited liability regime.⁷¹

⁶⁷ Supra 55 at 388-89.

⁶⁸ Supra 55 at 389.

⁶⁹ Ibid at 389.

⁷⁰ Ibid 389.

⁷¹ Supra 55 at 390.

Grundfest is additionally of the view that the result of the capital market activity would be a series of transactions which would arbitrage away the price effect of proportionate liability. The resulting price would be the same as if there had been the traditional limited liability regime. This would have the result of removing the price signals on which advocates of this argument rely, providing no additional assets on which the creditor could depend and which would insulate members from additional financial risk. Accordingly, proportionate liability would be able to influence capital market prices only to the extent that transaction costs inhibit arbitrage transactions that synthesise limited liability pricing.⁷²

One must note that it is not only proportionate liability that is incapable of succeeding in light of capital market arbitrage, but that any member liability rule that is different to that of limited liability would most probably be capable of being subject to capital market arbitrage.⁷³

3.3 **Delict versus contract**

Grundfest's argument is primarily concerned with and limited to delicts committed by the company where the company has creditors. The reason why he appears to be solely concerned with a delict and not with a situation where the company is in breach of or ill-performs under a contract is because when one contracts with a company, one is doing so knowingly and willingly, and with the company itself (not with its members).

With a contract, the parties are entering into the contract with their eyes open, fully aware of the consequences of non-performance, including limited liability. On the other hand, if a company commits a delict against a third party, such third party had no control over the situation and did not willingly allow for it to happen. Accordingly, it would seem equitable for innocent third parties to be awarded more protection, such that they may receive the usual delictual remedy of being placed in the same position they would have been in, had the delict not occurred. A regime of proportionate liability might not provide for this.⁷⁴

⁷² Ibid at 390.

⁷³ Ibid at 390.

⁷⁴ See *Botha v van Niekerk* 1983 (3) SA 513 (W). In this case this approach seems to be supported. This is not to say that proportionate liability could not be extended to breach of contracts, but rather that the argument in favour of the judgment creditor is more persuasive in such instances.

From the above it would appear that it is not prudent or practical to make members liable for damages which result from corporate conduct as the theory of proportionate liability has some inherent practical problems.⁷⁵

4. **Further alternatives to limited liability**

Three alternatives are proposed to limited liability and proportionate liability, which are a minimum capital requirement, product safety standards and “gatekeeper” liability provisions.⁷⁶ These three alternatives treat all companies equally and therefore do not generate artificial incentives to encourage companies to operate and be structured in one form over another.⁷⁷

4.1 **Minimum capitalisation**

Minimum capitalisation is a requirement resulting in the establishment of levels of equity capital or insurance which must be maintained in order for the company to conduct certain lines of business. This would include requiring the enterprises to have sufficient wealth to cover risk and to ensure that its actions are responsible when regulating its own activities.⁷⁸

Minimum capitalisation does, however, give rise to certain administrative problems, including the difficulty in setting the appropriate level of capitalisation. Further, the prescribed capitalisation levels could require constant amendment in light of new markets and technology trends from time to time. An incorrect estimation could induce a distortion in the market.⁷⁹

A benefit of minimum capitalisation is that it can be applied to listed companies, privately run companies as well as to domestic and foreign companies. It has its effect before the “capital markets even defines securities based on cash flow generated by these goods and services.”⁸⁰

⁷⁵ Supra 55 at 424- 425.

⁷⁶ Supra 55 at 421.

⁷⁷ Supra 55 at 423.

⁷⁸ Supra 55 at 421. Minimum capitalisation is the backbone of bank regulatory strategies.

⁷⁹ Supra 55 at 421.

⁸⁰ Supra 55 at 421-22.

4.2 **Product safety standards**

Product safety standards, whereby the legislator defines certain safety levels, could play a similar role to that of minimum capitalisation.⁸¹ Grundfest says that, if the regulators define safety standards, this could reduce the risk of events that threaten to generate liability in excess of corporate assets. Importantly these standards cannot be avoided through capital market activity because, regardless of arbitrage, the market for goods and services, which is where delicts occur, is subject to these standards. The problem may occur that, when setting such standards, mistakes may be made. As with minimum capitalisation, a level of subjectivity is required in setting the standards. Notwithstanding this, product safety standards would nonetheless heighten the standard of care that would be required to be followed by the company.⁸²

4.3 **“Gatekeeper” standards**

“Gatekeeper” standards are strategies that impose civil or criminal penalties on the decision-maker of the company who played a role in the company committing a delict. This strategy is popular for dealing with troublesome corporate conduct as the management or directors responsible will become liable for this action through the imposition of liability on them in their personal capacities. Not only will this act as a defence for improper governance but will ensure that, when the company is unable to pay its creditors, such creditors will not be out of pocket as they can recover the shortfall from the directors or management of the company. The “Gatekeeper” standards solution may be regarded as being akin to Section 424 of the Companies Act, but with a lower burden of proof in respect of the *mens rea* element, or perhaps without the *mens rea* element being required at all.⁸³

5. **Part 2 - What is Veil Piercing?**

Notwithstanding the relevant merits of the alternatives to limited liability, such alternatives remain, nonetheless, abstract theories. In reality limited liability is entrenched in our Law, including the many negative and or inequitable consequences thereof. Being cognizant of these, and in order to obviate same, our courts will, under limited circumstances, ignore

⁸¹ Supra 55 at 422.

⁸² Ibid at 422.

⁸³ Ibid at 422.

limited liability and “pierce the corporate veil” such that the members of the company may become liable for the actions of the company, in spite of their separate identities and the courts treat the companies members as if they were the owners of the companies assets and as if they were conducting the companies business in their personal capacities, or the court may attribute rights and/or obligations of the members on to the company.⁸⁴

5.1 The Philosophy behind veil piercing

A company’s separate existence is, by way of metaphor, described as a “veil”. This veil is said to separate the company from its members and protect the members from those who deal with the company. The corporate veil is a fundamental aspect of company law and is a protective device for those who exist behind it.⁸⁵

Pickering⁸⁶ notes that there are two reasons why there are exceptions to the separate entity doctrine. Firstly, he says that a company cannot at all times and in all circumstances be treated like an ordinary independent person. An example of this would be that a company has no *mens rea* and therefore is not capable of committing a delict or a crime, unless the court lifts the veil and imposes the intention of the directors or members on to the company. Secondly, if there were no exceptions to the separate personality rule, directors or members would be allowed to hide behind the shield of limited liability, with potentially disastrous effects.

5.2 Veil piercing by South African Courts

Because veil piercing is an exception to the rule of separate legal personality and not the rule itself, courts must be careful to permit veil piercing only in egregious cases. Accordingly, in this area of law it is stated time and time again that courts pierce the veil reluctantly.⁸⁷

In exceptional circumstances the veil is said to be “pierced.” When the court ignores the existence of a company, it treats the members as though they are the owners of the corporate assets and that they are conducting the business in their personal capacities. Another form of piercing the corporate veil is where the courts impute the rights and/or obligations of the members on the company.⁸⁸ Accordingly,

⁸⁴ M S Blackman, *The Law of South Africa's 'Companies'*, part 1 vol 4, W A Joubert (Ed), 1995, at para 41.

⁸⁵ *Supra* 6 p126.

⁸⁶ Pickering, *The Company as a Separate Legal Entity*, (1968) 31 M.L.R. 481 at 483.

⁸⁷ *Supra* 25 at 481 footnote 8.

⁸⁸ *Supra* 86 at para 41.

veil piercing is where the veil of incorporation is ignored in order to determine the individuals upon whom liability should be imposed.⁸⁹ It is important to note that when the courts pierce the corporate veil, they would be doing so only to determine the rights, liabilities and obligations of the parties in the instance before it and, for all other purposes, the company's separate existence and personality remains unaffected.⁹⁰

In the 1980 case, *Lategan v Boyes*⁹¹ the court gave a judicial affirmation of the veil piercing doctrine and said that there is "no doubt that our courts would brush aside the veil of corporate identity..."⁹² The court went further to say that it is trite law that a court would be justified, in certain circumstances, to disregard the company's separate personality in order to fix liability elsewhere.⁹³

It is further trite law that the disregarding of the separate personality of the company is not to be done casually, as stated in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others*⁹⁴, "*It is undoubtedly a salutary principle that our courts should not lightly disregard a companies separate personality, but should strive to give effect to and uphold it*"⁹⁵.

5.3 Conditions for piercing the veil

Although the law can interfere with the separateness of the company and upset the principle that every company is a separate legal entity with separate personality to its members,⁹⁶ the question remains - "Should the separate legal statues of the company be open to scrutiny through the doctrine of piercing the corporate veil⁹⁷ or should separate legal personality of the company be maintained at all times?"

According to, Maurice Worm; "*When the conception of corporate entity is employed to defraud creditors, to evade an existing obligation, to circumvent a statute, to achieve or perpetuate monopoly, or to protect knavery or crime, the courts will draw aside the web [i.e. the veil] of entity, will regard the corporate company as an*

⁸⁹ Supra 10 at 143.

⁹⁰ Supra 86 at para 41

⁹¹ *Lategan & Another NNO v Boyes and Another* 1980 (4) SA 191 (T).

⁹² *Lategan & Another NNO v Boyes and Another* 1980 (4) SA 191 (T) at 201.

⁹³ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 (4) SA 790 at 802 E.

⁹⁴ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 (4) SA 790 at 802 E at 803 H-I.

⁹⁵ Supra 7 at 189. The veil piercing doctrine originated in the United States of America, and therefore has Common law routes. In the United Kingdom, the courts are willing to pierce the veil, but do so reluctantly even in the strongest cases, whilst in the United States of America the courts will pierce the veil with less reluctance.

⁹⁶ Supra 6 at 124.

⁹⁷ *Ibid* at 124.

*association of live... men and women shareholders, and will do justice between real persons.*⁹⁸ Accordingly, it is necessary to look into the facts of each case and to consider the substance rather than the form of the entity.⁹⁹

The legal personality of a company is a matter of substance and not merely a technicality. Substance must not be cast aside for apparent convenience.¹⁰⁰

When the courts pierce the corporate veil, they impose a scheme of rights and obligations on the parties. These rights and obligations are very different from that upon which they arranged their affairs.¹⁰¹ Accordingly, when the courts pierce the veil, the effect thereof is substantial and is potentially damaging.

In order to pierce the corporate veil, it is arguable that there are at least two necessary conditions, which are required to be present.¹⁰² Firstly, there must be control and domination over finances, policies and practices to the extent that the company has no separate mind, will or existence from its members.¹⁰³ This, on its own, is however not sufficient, as highlighted by Lord Haldbury in the *Salomon* case; “*If there was no fraud and no agency, and if the company was a real one and not a fiction or a myth, every one of the grounds upon which it is sought to support the judgement is disposed of.*”¹⁰⁴ Accordingly, a sub-consideration of this first condition that must be taken into account by the courts prior to them intervening is whether the company is being used for the purpose of fraud or as a means to avoid other legal obligations.¹⁰⁵ Secondly, one must bear in mind that veil piercing is an exceptional procedure, and thus requires that exceptional circumstances be present before the court will pierce the veil.¹⁰⁶ The general rule is that the separate corporate personality should be upheld, except in the most unusual circumstances. The consequence is that the court will pierce the veil only if the plaintiff is unable to obtain another remedy and which will result in him suffering a massive injustice¹⁰⁷.

⁹⁸ Maurice Worm, *Piercing the corporate Veil of Corporate Entity*, 12 Colum. L. Rev. 496, 517 (1912). See supra 25 at 480.

⁹⁹ *Dadoo Ltd v Krugersdorp Municipality* 1920 AD 546.

¹⁰⁰ Supra 86 at para 43.

¹⁰¹ Ibid at para 43. See supra 76.

¹⁰² Ibid at para 43.

¹⁰³ Ibid at para 43.

¹⁰⁴ Supra 1 at 37. Supra 86 at para 43.

¹⁰⁵ Supra 10 at 145.

¹⁰⁶ Supra 86 at para 43. See *Woolfson v Strathclyde Council* 1978 SC 90 (HL) 96; *Re Securitibank Ltd (No 2)* 1978 2 NZLR 136 CA (NZ) 158; Supra 76 at 523; *Adams v Cape Industries plc* 1990 Ch 433; 1991 1 All ER 929 (Ch and CA); *Supra 95* at 819–821; *The Shipping Corp of India Ltd v Evdomon Corp Ltd* 1994 1 SA 550 (A)..

¹⁰⁷ Alternative remedies will be discussed in greater detail below.

5.4 **Legislation promoting transparency and accountability**

In certain cases, the legislation has disregarded the separate legal personality of companies in the interests of transparency and accountability.

It is important to note that a fundamental aspect of corporate legislation is that of transparency of the internal happenings of the company. This is evident in various sections of the Companies Act such as, *inter alia*, the requirement that the Articles of Association of the company be placed with the Registrar of Companies and the disclosure of the financial position of the company in its annual audited accounts, to name but a few. By removing the veil, the corporate operations become even more transparent. Those behind the veil become accountable for their actions.¹⁰⁸ It is pointed out that transparency and accountability are differing concepts and the legislator has also created legislation to avoid the company from being used to defeat the rights of third parties.

In various instances, the legislature has disregarded the principle of the separate legal personality of the company. This is generally used as a sanction for the non-compliance with the provision of an Act.¹⁰⁹

The legislature has demonstrated little reluctance in setting aside the separate entity rule¹¹⁰ as the legislature recognises that the benefits provided by the corporate form are capable of being abused by corporate managers or controlling members. This is, however, clearly indicative of the route in which the veil piercing doctrine is heading.

Set out below are examples of various specific provisions of local and foreign legislation which disregards separate corporate personality of a company and/or impose liability on directors or members.

5.5 **South African Legislation**

5.5.1 **Section 50(3) of the Companies Act¹¹¹**

In terms of section 50(3) of the Companies Act, if a director, officer or any person on the company's behalf issues or signs a bill of exchange, a

¹⁰⁸ Supra 6 at 151.

¹⁰⁹ Lexis Nexis: Corporate Commercial: legal personality: Disregarding the Separate Existence of the Corporate Entity para 1.23 p11.

¹¹⁰ Supra 23 at 309.

promissory note, a cheque or an order for money or for goods on behalf of the company [or authorises the issue or signing of such a document] in which the registered name of the company is not cited in the correct manner, it will amount to an offence. That person will be personally liable to the holder of that bill of exchange, promissory note, cheque or order for the amount thereof, unless it is duly paid by the company.

5.5.2 **Section 66 of the Companies Act**

Section 66 of the Companies Act provides that where a public company carries on business for more than six months while it has less than seven members, every person who is a member of the company during the time that it carries on business after those six months shall be personally liable for the payment of the debts of the company incurred during that time.

5.5.3 **Section 172(5)b of the Companies Act**

Section 172(5)b of the Companies Act provides that until a certificate is issued permitting the company to commence business any debts or liabilities incurred prior to receipt of the certificate is the joint and several liability of the directors and the members of the company.

5.5.4 **Section 280(5) of the Companies Act**

Section 280(5) of the Companies Act provides that if the directors of a Company fail to appoint an auditor to fulfil a vacancy after the receipt of written notice to do so by the Registrar the directors and the company shall be held jointly and severally liable for any debts incurred by the company during the existence of the vacancy.

¹¹¹ 61 of 1973 (the "Companies Act")

5.5.5 **Section 344(h) of the Companies Act**

In terms of section 344(h) of the Companies Act, a company may be wound up by the Court if it appears to the Court that it is just and equitable to do so. The actual state of affairs between the members may be looked at in determining whether the circumstances justify the winding up.¹¹²

5.5.6 **Section 424 of the Companies Act**

Section 424 of the Companies Act provides that, when it appears that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, 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.

5.5.7 **Section 332 of the Criminal Procedure Act¹¹³**

Section 332 of the Criminal Procedure Act imposes criminal liability upon a corporate body for the offences committed by its directors or servants in the performance of their duties or while furthering the interests of that corporate body.¹¹⁴ Further, where a corporate has been held criminally liable for an offence, its directors may bear the criminal sanction on behalf of the company, such as incarceration.

5.6 **Foreign legislation**

It is valuable to contrast the legislation in foreign jurisdictions so as to contextualise the South African situation. In this regard, the legislation of the United States of America is particularly useful, in light of its developed economy and advanced corporate and commercial legal system.

It is not uncommon in the United States of America for federal legislation to have provisions that will attach liability to the members of companies for the acts of that company. This would normally be in instances where an injustice will be caused to

¹¹² Supra 111 at para 1.23 p12.

¹¹³ Criminal Procedure Act 51 of 1977.

the parties dealing with the company as a result of its separateness. The wording differs slightly from Act to Act, but the common sentiment prevails.

Similarly, in Australia, an example of this can be seen in s16 of the Canals Act 1958-79 (Qld), in respect of liability for offence by bodies corporate:

“1) Where a body corporate offends against this Act, each and every one of the following persons shall be deemed to have committed the offence and shall be liable to be proceeded against and punished accordingly, namely

a) The managing directors, manager or other governing officer, by what ever name called, and every member of the governing body, by what ever name called thereof, and

b) Every person who in Queensland manages or acts or takes part in the management, administration, or government of the business in Queensland of the body corporate.

2) This section applies so as not to limit...the liability of a body corporate...”¹¹⁵

Thus, it is clear that foreign jurisdictions apply the principle of separate legal personality, but also limit it in certain circumstances (including in various statutes).

5.7 **When will the courts pierce the corporate veil?**

Deciphering when the courts will and will not pierce the corporate veil seems to be the most confused issue surrounding the doctrine, mostly because there seems to be very little consistency in the application of this doctrine by the Courts. There are various tests which have been developed by the Courts and academics alike. The predominant approach adopted by the South African courts is the categorisation approach (although some criticism has been levelled at this approach).

The courts have made it abundantly clear that they have no general discretion to simply disregard a company’s separate legal personality on a whim if they feel that it

¹¹⁴ Supra 111 at para 1.23 p12.

¹¹⁵ Supra 23 at 312.

is just to do so¹¹⁶ Limited liability is at the heart of the reason for the existence of the company and cannot be done away with, without the most compelling of indications. Therefore, as a general principle, it is incumbent on creditors to protect and enforce their rights and claims on traditional grounds, without having to pierce the corporate veil.¹¹⁷

5.7.1 **A common law examination of the tests and factors the courts have used when piercing the corporate veil**

General principles are important in any legal system as the application thereof ensures consistency and predictability. Instances when the veil can be pierced seem to fluctuate according to the judicial thinking at the relevant time.¹¹⁸ The lack of a single, clearly defined principle has resulted in a number of overlapping lists of factors which the courts are to consider. These factors have been passed off as tests.¹¹⁹ Whether an owner can be personally liable for a company's liabilities based on these factors is, according to Hawke "questionable and at times completely unexplained."¹²⁰

In *Securitibank Ltd (No 2)*¹²¹, Richmond P said: "*It may be... that the doctrine laid down in [the] Salomon [case]...has to be watched very carefully But that can only be so if a strict application of the principle of corporate entity would lead to a result so unsatisfactory as to warrant some departure from the normal rule... For myself, and with all respect, I would rather approach the question the other way round, that is to say on the basis that any suggested departure from the doctrine laid down in [the] Salomon [case] should be watched very carefully. I think that is particularly so in a case such as the present where there is no suggestion that the individual corporate entities . . . were in some way used to create a sham facade.*"

Similarly, in *Shipping Corporation of India Ltd v Eudan Corporation*¹²² Corbett CJ held that the separate personality of the company and the members is of utmost importance and that deviation from this rule should

¹¹⁶ Supra 95 at 803 A.

¹¹⁷ Supra 5 at 297 to 298.

¹¹⁸ PJ Payne, *Lifting the Corporate Veil: A Reassessment of the Fraud Exception*, The Cambridge Law Journal, 1997 284 at 284.

¹¹⁹ Supra 6 at 151.

¹²⁰ Supra 6 at 173. Whether an owner can be personally liable for a corporation's liabilities based on these factors is, according to Hawke "questionable and at times completely unexplained".

¹²¹ *Re Securitibank Ltd (No 2)* 1978 2 NZLR 136 CA (NZ) at 158 to 159.

¹²² *Shipping Corporation of India Ltd v Eudan Corporation* 1994 (1) SA 550 (A) at 566.

only occur in the rarest of cases. Such cases would be where there are elements of fraud or improper conduct present.

From the above, it appears that, the courts seem to be more willing to pierce the corporate veil if doing so will result in justice being achieved.¹²³

Similarly, in *Lategan v Boyes*,¹²⁴ Loux J stated that fraud is the essential requirement for piercing the corporate veil and that a fraud committed by the company need always be present before the courts can pierce the veil. Blackman comments that in *Lategan* the court did not intend to lay down such a strict fraud requirement, as in *Lategan* there was no fraudulent conduct.¹²⁵

In *Botha v van Niekerk*¹²⁶, Flemming J stated, that the statement in *Lategan* regarding fraud was incorrect. Flemming J formulated a test for veil piercing which was somewhat wider than the categorisation approach¹²⁷. The court held that there could be personal liability if it could be proved that the applicant had suffered an unconscionable injustice as a result of what a right-minded person would perceive to be improper conduct on the part of the respondent.¹²⁸ In such instances, mere equity is not sufficient.¹²⁹ Based on this test, the court held that the Applicant had contracted of its own accord and put itself in the position where it was only the company that was liable.

In *Cape Pacific v Lubner Controlling Investments (Pty) Ltd*¹³⁰ Smalberg J commented on the test set down by Flemming J and stated that the test of unconscionable injustice was too rigid and that a more flexible test was required, a test that required the courts to look at the facts of each case.¹³¹

In *Hulse-Reutter & Others v Godde*¹³² it was argued that the courts should pierce the veil in instances of improper or fraudulent conduct. In this case, “[the shareholders] had caused [the company] to enter into the agreement

¹²³ L Gallagher and P Ziegler, *Lifting the Corporate Veil in the Pursuit of justice*, The Journal of Business Law 1990 292 at 313.

¹²⁴ Supra 93 at 202.

¹²⁵ Supra 86 at para 44. See footnote 4.

¹²⁶ Supra 76.

¹²⁷ This is dealt with in greater detail below.

¹²⁸ Supra 76 at 525 F.

¹²⁹ Supra 86 at para 44. See footnote 18.

¹³⁰ Supra 95.

¹³¹ Supra 95 at 803.

with no intention of [the company] ever honouring its obligations in terms of the agreement.”¹³³ The court held, “*There can be no doubt that the separate legal personality of a company is to be recognised and upheld except in the most unusual circumstances. A court has no general discretion simply to disregard the existence of a separate corporate identity whenever it considers it just or convenient to do so.*”¹³⁴ *The circumstances in which a court will disregard the distinction between a corporate entity and those who control it are far from settled. Much will depend on a close analysis of the facts of each case, consideration of policy and judicial judgment... There must at least be some misuse or abuse of the distinction between the corporate entity and those who control it which results in an unfair advantage being afforded to the latter.*”¹³⁵ In determining whether there had been an abuse, the court looked at whether there had been a concealment of the identity of the members.¹³⁶

In *Hulse-Reutter*, the court departed from the *Cape Pacific* case without expressly stating so, and seemed to have reintroduced the requirement of unfair advantage into the test in determining whether or not to pierce the veil.¹³⁷ *Cape Pacific* expressly avoided holding that there must always be an unfair advantage before the court can pierce the veil, as this requirement was regarded as being too rigid.¹³⁸ This was, however, laid down as a requirement in *Botha v van Niekerk*¹³⁹.

Cape Pacific was decided on a flexible test and thus did away with the rigidity of *Botha v van Niekerk*. However, the court in *Hulse-Reutter* reverted to a rigid test (without an explanation as to why it did so).¹⁴⁰

It is very difficult to reconcile *Cape Pacific* and *Hulse-Reutter*. This is because *Hulse-Reutter* required there to be an “unfair advantage” as well as “no other remedy available”. Larkin and Cassim have asked the question as to whether this is the better approach to dealing with veil piercing and have concluded that, if this is the correct approach, it may bring about the

¹³² *Hulse-Reutter & Others v Godde* 2001 (4) SA 1336 (SCA).

¹³³ *Supra* 134 at para 15.

¹³⁴ *Supra* 95 at 803 A-H.

¹³⁵ *Supra* 134 at para 20.

¹³⁶ Larkin and Cassim, *Company Law, The Annual Survey of South African Law* 2001, Juta 506 at 515.

¹³⁷ *Ibid* at 515.

¹³⁸ *Ibid* at 515.

¹³⁹ *Supra* 76 at 525 F.

¹⁴⁰ *Supra* 138 at 515.

doctrine's destruction. In this regard, Larkin and Cassim have stated "for what is there that can make any advantage unfair if there is no remedy in law against it? Or, if an advantage is unfair why would there not be a legal remedy against it?"¹⁴¹

5.8 Tests

5.8.1 Good commercial reason test

Courts have considered the test of "good commercial reason" - if it makes good commercial sense to have created a limited liability company, then the courts may not pierce the corporate veil. However, with the 'good commercial reason test' an inherent flaw seems to be that any acquisition, formation or use of the corporate structure would always satisfy it, as it can almost always make good commercial sense to make use of the corporate structure.¹⁴²

5.8.2 Promotion of private interests / "alter ego"

The courts have also used the doctrine of piercing the corporate veil in instances where the controlling members do not treat the company as a separate entity but rather utilise it to promote their private interests. Accordingly, the company is treated as the "alter ego" of the members.¹⁴³ Beyond that, however, the Courts would only pierce the veil if it is in the interest of justice and fairness or right dealing.¹⁴⁴

5.8.3 The Control Test

The "Control test" is allied to the "Alter ego test" discussed above. In terms of this test, where the members of the company have control and ownership over the company and where they have domination of the financial policy so that the company has no separate mind of its own, the courts have pierced the corporate veil.¹⁴⁵ In the *Greater Johannesburg*¹⁴⁶ case, the court said the

¹⁴¹ Supra 138 at 517.

¹⁴² Supra 120 at 285.

¹⁴³ Supra 25 at 490.

¹⁴⁴ Ibid 490

¹⁴⁵ Supra 86 at Item 43.

¹⁴⁶ *Greater Johannesburg Transitional Metropolitan Council v Eskom* 2000 (1) SA 866 (SCA).

control test is appropriate “for the purpose of deciding whether a public company is the “alter ego” of the government that established it.”¹⁴⁷

Larkin and Cassim state that, insofar as the control test is concerned, it is not control itself that will make the company the instrument of the controller and justify the veil being pierced, but rather the manner in which the control is exercised.¹⁴⁸

5.9 **Categorisation in general by the courts**

Various categories have been established by the courts to assist them in their examination of whether to pierce the veil. These include “in the interests of justice”, “equity”, “fraud or improper conduct”, “under-capitalisation”, “formalities”, “the single economic unit” and “alter ego” or “agency”. Matheson and Eby state that some courts will list all the factors and then attempt to synthesise them to the case at hand.¹⁴⁹

A thorough examination of the various categories is required to determine whether this “categorisation approach” is a successful method. It will become evident that these categories have inherent flaws and do not make for a very compelling argument as a means by which the courts can disregard the separate personality of the company.

It is, however, understandable why the courts have tried to define situations, or categorise, where the corporate veil may be pierced. However, not every case falls within a specific category and, as such, it is necessary to determine whether the veil should be pierced by reference to the surrounding facts and circumstances. The criticism around the categorisation approach will be dealt with below.

5.9.1 **“In the interest of justice”**

The category of “in the interest of justice” provides the policy impetus for allowing exceptions to the doctrine of limited liability. Thus, the courts will pierce the corporate veil in instances where it would result in justice prevailing. The problem with this category is that the notion of the “interests

¹⁴⁷ *Greater Johannesburg Transitional Metropolitan Council v Eskom* 2000 (1) SA 866 (SCA) para 12.

¹⁴⁸ Larkin and Cassim, *Company Law The Annual Survey of South African Law* 2000, Juta 486 at 491.

¹⁴⁹ *Supra* 32 at 174. See American case *White V Winchester Land Dev Corp.* 584 S.W.2d 56, 61-62 (Ky. Ct.App.1979).

of justice” is vague and gives very little guidance as to when separate legal personality should be disregarded.¹⁵⁰

Case law provides some guidance in this regard. In *Botha v van Niekerk*¹⁵¹, the court held that it would render someone other than the company liable for its debts if “an unconscionable injustice” had been suffered as a result of what was, to the “right-minded person”, conduct that was “clearly improper”.¹⁵² However, the terminology used in this case is equally vague and subjective and thus whether further light has been shed on the issue is questionable.

5.9.2 **Fraud or improper conduct**

Related to the category “in the interest of justice” is “fraud and improper conduct”.

L Gallagher and P Ziegler state that the second most commonly cited reason for piercing the veil is fraud. The reason for this is that the courts endeavour to achieve justice for the parties involved.¹⁵³ They argue that all the different categories which the courts use to pierce the veil are merely subsets of one category, the prevention of injustice. The authors state that traditionally the prevention of injustice was merely a category used for determining whether or not the veil should be pierced. This, they argue, is the exception to the separate personality of the company, with other exceptions being subsets of this general principle,¹⁵⁴ as each of the categories are aimed at preventing an injustice to the parties concerned.¹⁵⁵ Most decisions indicate that where there is an avoidance of an existing obligation and such avoidance would result in an injustice, then it would result in the veil being pierced.

Recent cases have shown that the courts will pierce the corporate veil in circumstances where a company has been used to carry on unlawful activities, to avoid the impact of a court decision,¹⁵⁶ to conceal a wrongdoing or to avoid obligations.¹⁵⁷ Similarly, the veil has been pierced by the court in

¹⁵⁰ Supra 32 at 187.

¹⁵¹ Supra 76.

¹⁵² Quoted from Supra 5 at 279.

¹⁵³ Supra 125 at 302.

¹⁵⁴ Supra 125 at 307.

¹⁵⁵ Ibid at 307. It is argued that when the courts have expressly pierced the veil due to a prevention of an injustice, it is because the

courts are unable to rely on any of the other exceptions. See *Re Bugle Press Ltd* [1961] Ch. 270L.

¹⁵⁶ Supra 7 at 187.

¹⁵⁷ See *Adams v Cape Industries Plc* 1990 ch 433 544; 1991 1 ALL ER 929 1026 (Ch and CA)

instances where a person, having no legal power to act in his own right, creates the power by setting up a company and going through a “sham” transaction, so to empower it to do what he himself could not do independently.¹⁵⁸ However, the courts will not pierce the veil merely because the device of a corporate structure is used to evade such rights or relief that third parties may in the future acquire.¹⁵⁹

*Dadoo Ltd v Krugersdorp Municipal council*¹⁶⁰ makes it clear that the courts will pierce the veil if the corporate form is abused and used for an improper or unlawful use.¹⁶¹ In this case, the court held that if a transaction may “in truth be within the provisions of [a] statute, but the parties may call it by a name or cloak it in a guise, calculated to escape those provisions...the court would strip off its form and disclose its real nature and the law would operate.”

In *Lategan v Boyes*,¹⁶² the courts pierced the veil where there existed fraud. In this case, the company was held liable for the obligations of the member.¹⁶³

It is not unlikely for a company to carry on its affairs and to avoid being subject to certain pieces of legislation. This does not mean that a person may not deliberately arrange his affairs in order to avoid being hit by the statutory provisions.¹⁶⁴ If a person does arrange his affairs “and honestly intends what he has done to have effect according to its tender, the only question will be whether what he has done falls within or without those provisions.” But when it is done in a way so that the company can do something which the person is, in his own capacity, prohibited from doing via statute, then the courts can treat the acts of the company as the acts of the person.¹⁶⁵

It is accordingly well established that the courts will pierce the veil where the company is used for fraudulent means, or as a means to evade contractual or legal obligations.¹⁶⁶ The problem is that this exception which was mentioned

¹⁵⁸ Supra 86 at para 43. See *Re Bugle Press Ltd* 1961 Ch 270, 1960 3 ALL ER 791 (CA).

¹⁵⁹ Ibid at para 43. See Supra 159.

¹⁶⁰ Supra 101 at 548.

¹⁶¹ See *Gifford Motor Co v Horne* [1933] Ch 935.

¹⁶⁴ Supra 93 at 200-201.

¹⁶³ Cilliers and Benade, *Company Law*, (4th Ed) Butterworths 1982 at 14.

¹⁶⁴ Supra 86 at item 43.

¹⁶⁵ Supra 86 at item 43.

¹⁶⁶ Supra 120 at 284.

in the *Salomon* case is not as straight forward as it seems and can become confused.¹⁶⁷

Hawke and Payne both note that timing and motivation are important with regards to the fraud category, but that they cannot be over simplified. This is due to the complex nature of commercial and related arrangements.¹⁶⁸ There will generally be a connection between the two. Motive has been held to be of relevance in *Adams*¹⁶⁹, *Tjaskemotesrs*¹⁷⁰, *Gilford Motors Co*¹⁷¹ and *Jones v Lipman and Ringway*¹⁷² But Hawke says motive begs the question about the nature and purpose behind the use of the corporate form¹⁷³ and the objective of the arrangement.

Firstly, one needs to consider whether the motive of the person who is practising the deception is of any relevance.¹⁷⁴ In *Adams*, Slade LJ held that one must look to see if the company is a façade which is concealing the true facts.¹⁷⁵ Slade LJ said that with such a test the “motive of the perpetrator may be highly material.”¹⁷⁶ The difficulty here is trying to ascertain what those motives need to be.¹⁷⁷

In an analysis of *Gilford Motors*¹⁷⁸ and *Jones v Lipman and Ringway*¹⁷⁹, it is noteworthy that, in both cases, the defendant intended to deceive the plaintiffs, thus denying the plaintiffs their legal rights by using a corporate form. Is such a motive necessary for the fraud exception to be applicable?¹⁸⁰ In the *Adams* case, there was no evidence of unlawful intentional behaviour to deny the plaintiff rights which had already come into existence.¹⁸¹ Thus the question is “Is it enough for the defendant to intend to set up a company and intend thereby to create a smoke screen between himself and the plaintiff...but without intending to deny the plaintiff of any legal rights” for the

¹⁶⁷ Ibid at 284.

¹⁶⁸ Supra 6 at 149.

¹⁶⁹ Supra 159.

¹⁷⁰ *Tjaskemolen* [1997] 2 L.I. rep. 465.

¹⁷¹ Supra 163.

¹⁷² *Jones v Lipman Ringway* [1998] 2 B.C.L.C, 625.

¹⁷³ Supra 6 at 149.

¹⁷⁴ Supra 120 at 286.

¹⁷⁵ Supra 159 at 539.

¹⁷⁶ Ibid at 542.

¹⁷⁷ Supra 120 at 286.

¹⁷⁸ Supra 163.

¹⁷⁹ Supra 174.

¹⁸⁰ Supra 120 at 286.

¹⁸¹ Supra 120 at 286-87.

fraud exception to be applicable?¹⁸² This, says Payne, is a question which goes to the quality of the right. The court in *Adams* appears to have been correct in stating that motive was relevant, but without any further guidance, this statement is unhelpful.¹⁸³

Secondly, one needs to consider whether or not the nature of the obligation will have any effect as to whether the courts will pierce the veil. Payne states that, in order for the fraud exception to succeed, there needs to be a pre-existing legal right. Thus, if such a pre-existing legal right is not in existence, the intention to deceive the plaintiff is purely speculative. “If the legal right crystallises before the corporate form is used to evade the right, then all is well and good because the defendant intends to use the company to deny the plaintiff that legal right, and the mental element is satisfied.”¹⁸⁴ If the legal right was established only after the company has been formed, then the mental element would be impossible to satisfy.¹⁸⁵

Thirdly one needs to consider whether the time of incorporation of the company is of any relevance in ascertaining fraud. In *Creasey v Breachwood Motors Ltd*¹⁸⁶ the argument based on fraud was unsuccessful due to the timing of the incorporation of the “sham” company.¹⁸⁷ The court noted, in the *Creasey* case, that the company was in existence and carrying on its business as opposed to being formed purely to carry out the fraud.

Payne states, however, that it should be irrelevant whether the company was in existence prior to the fraud, but simply if at some stage there was in fact a fraud committed.¹⁸⁸ As long as there is “the intention to use the corporate structure in such a way as to deny the plaintiff some pre-existing legal right,”¹⁸⁹ then the fraud exception can be invoked. The “sham” company should not need to be incorporated purely for the purpose of committing the fraud.¹⁹⁰

¹⁸² Supra 120 at 287.

¹⁸³ Ibid at 287.

¹⁸⁴ Supra 120 at 288.

¹⁸⁵ Ibid at 288.

¹⁸⁶ *Creasey v Breachwood Motors Ltd* [1993] B.C.L.C. 480.

¹⁸⁷ Supra 120 at 288.

¹⁸⁸ Supra 120 at 289.

¹⁸⁹ Supra 120 at 290.

¹⁹⁰ Ibid at 290.

5.9.2.1

Examples through Case Law

Case law provides example of where the corporate veil has been pierced in instances of fraudulent or dishonest conduct. It is necessary to examine these cases to provide some guidance as to the case-by-case analysis conducted by the courts in piercing the corporate veil.

In *Robinson v Randfontein Estate Gold Mining Co Ltd*¹⁹¹, a director of a company (A Co) bought property with the intention of selling it to (A Co) at a profit. In order to avoid being in breach of his director's fiduciary duties, he set up a company (Y Co), to whom he would sell the property. (Y Co) would then sell it to (A Co). In this case, the court disregarded the intermediary company and pierced the corporate veil.

In *Re a Company*¹⁹², a network of interrelated companies had been established and structured so that the companies' assets would be placed beyond the hands of the creditors. In this instance, the courts pierced the corporate veil.

In *Re H*¹⁹³ the court noted that there was evidence that the company, which was controlled by the applicant, was *prima facie* a cloak for criminal activity. Accordingly, the court pierced the corporate veil to allow for the assets of the company to be treated as though they were assets of the applicant.

In *Gilford Motors*¹⁹⁴, the court was concerned with a restraint of trade clause. The former employee set up a company and solicited customers through this newly formed company in an attempt to circumvent his obligations under and in terms of the restraint. The court held the company to be a "sham" or a "cloak" and thus restrained the company from acting as it did.

¹⁹¹ *Robinson v Randfontein Estate Gold Mining Co Ltd* 1920 AD 16A.

¹⁹² *Re a Company* 1985 BCLC 333 (CA).

¹⁹³ *Re H* [1996] 2 ALL E.R. 391.

¹⁹⁴ *Supra* 163.

In *J Louw and Co (Pty) Ltd v Richter*¹⁹⁵, a case also concerned with a restraint of trade clause, Dittcott J refused to follow the decision in *Gilford Motors* and said that “to call *Richter* to book for his own transactions channelled through the company was one thing,” but to treat the company “as if it had incurred an obligation which it never did, an obligation which [the member] instead incurred at a time when [the member] had no connection with it because it did not yet exist, is surely another.”¹⁹⁶ The court said that the company, in this case, was established innocently, whilst in *Gilford Motors* it was established so that it could do what the member was not at liberty to do personally.¹⁹⁷

In *Die Dros (Pty) Ltd and Another v Telefan Beverages CC and Others*,¹⁹⁸ another restraint of trade case, there was a clause which prohibited a franchisee (X) from carrying on a restaurant business for a 12 month period within a certain region upon termination of the franchise agreement. Notwithstanding this, (X) became involved in a business called ‘De Kelder Restaurant’ which operated as a close corporation (the interest in which was held by (Y), (X’s) brother). The court noted that it is trite law that the courts could pierce the corporate veil in cases of breach of restraint of trade clauses, this being on the condition that it could be proven that the close corporation was being used as a front to engage in activities that were otherwise prohibited. In the case at hand, the court found that there were insufficient facts to show that the close corporation was being used as an instrument of business to promote the personal affairs of X.¹⁹⁹

In *Tjaskemolen*²⁰⁰, the company (Bayland Navigation, part of the Fandel Group), was formed for the sole purpose of owning the ship Bayland. The ship was sold to Golden International Navigation SA, another company within the group. The ship was then attached as security, but it was argued that the ship no

¹⁹⁵ *J Louw and CO (Pty) Ltd v Richter* 1987 (2) SA 237 (N).

¹⁹⁶ For a fuller discussion as to how one can distinguish the two cases see Supra 86 para 45, footnote 8.

¹⁹⁷ Blackman notes that the distinction is incorrect. Supra 86 para 45. In Supra 95 at 804 the court held that it is not necessary for a company to have been created and founded in deceit and to never have the intention to function genuinely before the corporate veil can be discarded.

¹⁹⁸ *Die Dros (Pty) Ltd and Another v Telefan Beverages CC and Others* 2003 (4) SA 207 (C).

¹⁹⁹ Derebus, The Law Reports, 2003.

longer belonged to Bayland Navigation. The court held that the arrangement was a sham to avoid the arrest of the vessel, that there was no genuine commercial transaction and that it was not intended that Golden International Navigation should pay the full purchase price. The court thus looked at motive and intention, and pierced the corporate veil.

In *Denel (Pty) Ltd v Gerber*²⁰¹, a person rendered services to another through a corporate and received payment through that corporate. Notwithstanding this, she was nonetheless deemed to be an employee of the company to which she was rendering services by the court. The court held that, “*the mere fact that use has been made of a legal entity ...to provide services is no bar to a conclusion that someone who is part of the company...or who owns the company ...contractually obligated to provide such services to the alleged employer is an employee of the company contractually entitled to receive such services.*”²⁰². The learned judge went on to say, “*I propose to determine this [case] having regard to the realities, to substance rather than form and to the true relationship rather than the appearance of the relationship.*”²⁰³

There is some foreign case law that indicates that the veil can be pierced even in instances where there is no fraud or agency. Such an example is *R v Hammersmith and Fulham London Borough Council, ex parte People Before Profit*²⁰⁴, where there was no use of the company as an “alter ego”, nor was there fraud present, yet the court still pierced the corporate veil. The reasoning as to why the veil was pierced seemed to be that the twin test of “alter ego” and fraud would only be applicable in situations where the application to have the veil pierced is made by someone outside of the company. However, if the request is made by someone inside of the company it would seem as though these tests would not be of much use.²⁰⁵

²⁰⁰ Supra 174.

²⁰¹ *Denel (Pty) Ltd v Gerber* [2005] 9 BLLR 849 (LAC).

²⁰² Supra 203 at para 93

²⁰³ Supra 23 at para 100

²⁰⁴ *R v Hammersmith and Fulham London Borough Council, ex parte People Before Profit*, 80 LGR 322, 1983.

²⁰⁵ Supra 11 at 23.

It is thus apparent that the courts will disregard the limited liability of a company when the company is merely a sham and is concealing the true facts.²⁰⁶ The problem is, however, in identifying what it is exactly that makes the company a mere façade.²⁰⁷ English courts have noted²⁰⁸ that there is little guidance in deciding whether or not a company is a façade. Although fraud is a well established category for piercing the veil, it is also evident that this category is not easy to apply in practice, having regard to the difficulties with the issues such as motive and intention.

5.9.3 Equity

Benade argues that the separation between companies and its members would not be in violation of company law if the separation of the two were for reasons of equity.²⁰⁹

The equity argument has two elements. Firstly, the policy based argument, that it is unfair to allow the owners of the company to avoid debts at the expense of the creditors of the company. Secondly, the allegation that the owner acted fraudulently or that he disposed of the company's assets so as to prejudice the company and the creditors.²¹⁰

According to Matheson and Eby, the first element contradicts commercial activity because once it is accepted that the law acknowledges that a company can have limited liability, "then the perceived unfairness to creditors should not be either a subject of judicial discussion or the basis of a decision to waiver an owner's statutory limited liability."²¹¹ The second element shows that the "equity" category may not be separate from the "fraud" category (although, it is acknowledged that the courts have looked at equitable solutions in arriving at decisions). Matheson and Eby note that any court that

²⁰⁶ Supra 7 at 185.

²⁰⁷ Supra 7 at 184.

²⁰⁸ Supra 7 at 185.

²⁰⁹ Supra 5 at 282. See Benade 226-227.

²¹⁰ Supra 32 at 178.

²¹¹ Supra 32 at 179.

is basing its decisions on equity will disregard the limited liability of an entity, the reason being that the very concept of limited liability is inequitable.²¹²

While some courts use equity as a gloss when considering the “alter ego” category, other courts have pierced the corporate veil based on equitable situations alone.²¹³

5.9.4 **Undercapitalisation**

There is no authority in South Africa allowing the courts to pierce the corporate veil in circumstances where a company has insufficient capital. Some authors are of the view that there is no reason as to why the courts should be prohibited from piercing the corporate veil for this reason. The courts in the United States of America have made use of this category²¹⁴ and have pierced the veil in circumstances where a company is incorporated with insufficient funds to satisfy creditors if debts become due and payable.

The problem with the above category is if one is to deprive a small business owner of the protection of limited liability due to his/her indebtedness, it would be contrary to the very existence of limited liability and would be contrary to efficient business practice.²¹⁵ When a company has debt that is in excess of its assets, holding the member personally liable fails to take into account that most businesses are very highly leveraged.²¹⁶ Further, from the first day of operation, it is not uncommon for a company to have insufficient assets to cover all of its debts.²¹⁷

The requirement for a newly incorporated company to have sufficient capital to cover all its debts will result in entrepreneurial markets being closed, defeating one of the main objectives behind limited liability. If the courts set minimum standards ensuring that creditors would be sufficiently covered this would operate as a bar to those who want to join the market.²¹⁸

²¹² Supra 32 at 180.

²¹³ Supra 32 at 233.

²¹⁴ Supra 7 at 189.

²¹⁵ Supra 32 at 177. Fraud has been discussed in greater detail above.

²¹⁶ Ibid at 177. See footnote 138.

²¹⁷ Supra 32 at 176.

²¹⁸ Supra 32 at 177-178. One must note that this is American Law.

It makes very little business sense to put more money than is necessary into a new company, as the greater the amount of capital investment into a company, the smaller the return on equity, resulting in a less successful investment. It seems illogical to penalise business owners for operating their business with business acumen.²¹⁹ Accordingly, a balance needs to be struck between a business environment that facilitates economic growth, whilst protecting the rights of participants therein.

5.9.5

Formalities

Procedures which the corporate members must follow are set out in legislation and specifically in the Companies Act. Most of the procedures are in place to protect the members from mistreatment by the directors or the owners.²²⁰ Notwithstanding this, the courts have, in some cases, disregarded the separate legal personality of a company in cases where the members have failed to comply with corporate formalities.

The courts often justify piercing the corporate veil on the failure to comply with corporate formalities on the basis of either 'privilege' or 'quid pro quo'. This is based on the assumption that an owner's failure to comply with the statutory requirements is an indication of the owner's lack of respect for the separation which is demanded by the law, which is the basis of their limited liability and is an indication of whether the individuals who are involved actually see the company as a separate entity.²²¹

The assumption has been argued to be incorrect in situations where the veil is pierced where there are small groups of owners.²²² These owners are often over-worked and tend to overlook the formalities that are of no importance to the actual operation of the business. Further, they, the business owners, are not legally trained, and are unable to pay attorneys to keep track of their statutory obligations. Accordingly, the failure by these business owners to comply with often expensive and burdensome statutory obligations is not a good indication of an abuse of doctrine of limited liability.²²³

²¹⁹ Supra 32 at 178.

²²⁰ Supra 32 at 175.

²²¹ Ibid at 175.

²²² Supra 32 at 176. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev 1036, (1991) at 1047-66.

²²³ Ibid at 176.

Matheson and Eby argue that “the failure of a company’s owners to observe corporate formalities has no relevance to an individual creditor’s claim against the owners, unless the non-observance of formalities is causally related to the creditor’s harm.”²²⁴

The above arguments make it clear that piercing the veil based purely on the failure by an owner to follow certain statutory formalities, is fatally flawed.

5.9.6 **The single economic unit**

Each company within a group of companies constitutes a separate legal entity. Each entity possesses separate rights and obligations. In certain circumstances, the court will ignore the distinction between the various companies in a single group and treat it as though it is a single economic unit.²²⁵ This results in the companies, although they are all independent, being regarded as part of the constituent group of companies, effectively piercing the corporate veil. Here, the critical question is one of control. This is a question of fact. Blackman notes that courts most commonly pierce the corporate veil where the holding company has such control over the subsidiary that the subsidiary is in fact carrying on the business of the parent company, resulting in the subsidiary being a façade.²²⁶

Where there is little or no control, this will assist the courts in finding that agency is not present. However, the existence of overriding share control in the subsidiary, is *per se* not sufficient to justify an agency relationship.²²⁷ This is therefore a question mostly of fact and partially of equity, but there is no presumption that the subsidiary is the “alter ego” of the parent company.²²⁸

²²⁴ Ibid at 176.

²²⁵ Supra 7 at 184.

²²⁶ See *DHN Food Distributors Ltd v London Borough of Tower Hamlets* 1976 3 ALL ER 462. Supra 86 at para 46.

²²⁷ Hawke says that contracts can be said to be shams and therefore unenforceable. Therefore he says the enforcement of contracts between parties can be highly dependent on the issue as to whether there is an agency relationship present. Supra 6 p151. See *Kodak Ltd v Clark* (1903) 4 TC. 549.

²²⁸ See Supra 159.

In *Smith Stone and Knight v Birmingham Corporation*²²⁹ six questions were noted as being relevant in ascertaining whether the subsidiary was carrying on the business of the holding company: 1) Were the profits of the subsidiary treated as though they belonged to the parent company? 2) Was management appointed by the parent company? 3) Was the parent company the head and brain of the trading venture? 4) Did the parent company govern the new ventures of the subsidiary and decide what should be done and how the capital should be structured and expanded 5) Did the parent company's skill and direction make the profits for the subsidiary? and 6) Was the parent company in constant control of the subsidiary?²³⁰

Cilliers and Benade state that the factors to be considered are: 1) Was there a degree of control by the holding company over the subsidiary? 2) Is there an utter identity and community interest between the holding company and the subsidiary? and 3) If the subsidiary and the holding company are treated in isolation, would it lead to an unjustifiable inequity?

Hawke notes that, with group relationships, the courts are willing to pierce the corporate veil where there is an avoidance or manipulation of liabilities or where it is seen to be necessary to rationalise or adjust rights or obligations.²³¹ Where a subsidiary is used as a device in order, for example, to avoid the directors having to abide by their fiduciary duties in the holding company, the courts refuse to take into account the separate existence of the subsidiary and the holding company.²³²

5.9.7

“Alter ego”

The “Alter ego” category has similar characteristics to the “single economic entity” category. The “Alter ego” category is where the company does not carry on its own business or affairs, but rather acts in the furtherance of the affairs of the controlling members, resulting in the situation where the controlling members do not treat the company as a separate entity.²³³ Accordingly, the company is merely a conduit for the controlling members to carry on their own personal business, resulting in an abuse of the

²²⁹ *Smith Stone and Knight v Birmingham Corporation* [1939] 4 ALL ER 116.

²³⁰ *Supra* 231 at 121.

²³¹ *Supra* 6 at 146.

²³² *Supra* 165 at 14.

²³³ *Supra* 86 at para 46.

separateness of the company.²³⁴ Courts have, in these cases, pierced the corporate veil²³⁵.

5.10 Problems with the categorisation approach

The categorisation approach has resulted in the courts sending conflicting messages. Not only are there inconsistencies in the manner in which the courts apply these various categories, but the factors taken into account can be argued, with a degree of certainty, to have inherent flaws. Yet, with all this in mind, there seems to be very little development by the courts in this area and there is little indication that the courts intend to grapple with these difficult concepts in an attempt to unify the considerations in a uniformly applicable manner.

Domanski²³⁶ supports the view that there are flaws in the categorisation approach as a means of deciding whether the veil should or should not be pierced²³⁷. A situation could arise, says Domanski, where considerations such as fairness, public policy or equity would call for the courts to pierce the corporate veil, but the courts would be unable to categorise the particular issue into one of the defined categories, resulting in the courts being unable to pierce the corporate veil and a massive injustice to the parties. This sort of situation indicates that the categorisation approach does not assist with the problems already surrounding veil piercing.

Other commentators argue that the decision to pierce the corporate veil is not based on a single factor, but that various elements are required to be considered. The courts should consider elements such as injustice or fundamental unfairness.²³⁸ According to L Gallagher and P Ziegler, the discrepancy between the various cases is not problematic, but rather indicates that the courts want to make decisions based on evidence of an injustice being caused to the parties.²³⁹ It might be, for this very reason, that there has been a reluctance to create a rigid category of circumstances as to when the veil will and will not be pierced.²⁴⁰ The argument, in this regard, is that a flexible approach is required, to ensure that the veil is pierced in the

²³⁴ Ibid at para 46.

²³⁵ Supra 25 at 490.

²³⁶ Andrew Domanski, *Piercing the Corporate Veil- A New Direction*, SALJ 103 (1986) 224 at 225

²³⁷ Domanski looks at two cases one being, an English case, Supra 206 and a Malawi decision, *Yanu-Yanu Co Ltd v Mbewe and Mbewe*, civil cause 121 of 1982 (unreported) to highlight the dangers of using a categorisation approach with regards to this area of law.

²³⁸ Supra 125 at 300.

²³⁹ Ibid at 300.

²⁴⁰ Ibid at 300.

appropriate circumstances, having regard to the separate and distinguishable facts of each case.

Carteaux notes that using a flexible, balancing approach would render decisions in the area of piercing the corporate veil vulnerable to subjective determinations of the equities involved and of the ways in which competing problems should be weighed. Carteaux argues that the maintenance of the traditional categories, such as fraud and agency, may reduce the risk of subjective and arbitrary decisions. The categorisation approach is only to be used as evidence supporting policies, rather than to justify piercing.²⁴¹ By maintaining the categories, one introduces an objective element to the balancing test.²⁴²

5.10.1 **Commentators tests**

Various commentators have proposed their views as to the appropriate test to be adopted.

5.10.1.1 **Blackman**

Blackman²⁴³ requires that there be special circumstances in existence prior to the court piercing the corporate veil. These circumstances must indicate that the company is a mere façade concealing the true facts. Accordingly, this will result in the separate existence of the company being abused or, at the very least, not being maintained in the full sense. Thus, the veil will be pierced in the case of fraud.²⁴⁴ Instances where the company was set up as a mere façade concealing the true facts would be, for example, where the company has been incorporated to avoid certain statutory requirements.²⁴⁵ Larkin comments in this regard that “the theory underlying this approach would have to be that only a ‘real’ company, a company in substance and not just in form can claim separate entity status.”²⁴⁶

²⁴¹ Supra 238 at 234.

²⁴² Ibid at 234.

²⁴³ Supra 86 at para 44.

²⁴⁴ Supra 150 at 490.

²⁴⁵ Supra 101 at 530. *Commissioner of Customs and excise v Randles Brothers and Hudson* 1941 AD 369.

²⁴⁶ Supra 5 at 284.

The theory of this test is hard to fault, but its application can be difficult in practice because there is no certainty or guiding principle to follow which shows how to recognise a “sham” company (where the members are hiding behind the separate persuading of the company).²⁴⁷

5.10.1.2

Benade

Some commentators are in favour of the development of the veil piercing doctrine and are of the view that our law, as it stands in respect of veil piercing, is too conservative. Benade is of the view that the veil can be pierced on the basis of equity alone.²⁴⁸

Benade argues that the separation between companies and their members is only relevant for some of the consequences of incorporation, as sometimes the company is viewed as a single unit and other times it is seen as comprising of individual members. Benade is of the view that there would be no violation of company law if the separation between the members and the company was left out for the purpose of equity.²⁴⁹

The second strand of Benade’s argument is that the concept of the separate entity is not an absolute one, but was designed for a purpose. Thus, if this entity concept circumvents the law, it would go against what it intended to achieve. Based on this argument, there should be no objection as to why a company should not be seen as a collection of individuals, as opposed to a separate entity, when it is required for the purposes of equity.²⁵⁰

5.10.1.3

Domanski

Domanski has argued for an approach in terms of which “the policies behind the recognition of a separate corporate existence must be balanced against the policies justifying piercing.”²⁵¹

²⁴⁷ Ibid at 284.

²⁴⁸ Supra 5 at 281.

²⁴⁹ Supra 5 at 282.

²⁵⁰ Ibid at 282.

²⁵¹ Supra 5 at 281.

Domanski argues that the separate personality of the company lies at the cornerstone of our law. Accordingly, Domanski's test advocates a cautious approach, with the protection of the separate personality being the foremost consideration.²⁵² Domanski, however, argues that the test of gross abuse of the separate personality is too restrictive and that simple abuse should suffice for piercing the corporate veil.²⁵³

5.11 Tests in Other Jurisdictions

It is useful to examine the case law applicable in foreign jurisdictions, as these decisions may provide insight into the issue of piercing the corporate veil and the flaws identified above.

In the English *Hammersmith*²⁵⁴ case, the Court held that common sense must prevail.²⁵⁵ The court stated that the veil may be pierced on common sense, irrespective of the legal soundness of the reasoning.²⁵⁶ This decision indicates a holistic and substantive approach to the issue, with equity, through common sense, prevailing.

The courts in England have also pierced the corporate veil in order to enforce commercial realities or expectations.²⁵⁷ This indicates that the English courts are willing to re-write commercial bargaining in certain cases.²⁵⁸

In *Catamaran Cruisers Ltd v Williams and Others*²⁵⁹ the court came very close to the limit beyond which it may be seen to be re-writing commercial bargaining. This case involved an "employee" who had offered services to an employer through a company. The court held that the claimant was still an employee. The court held "there is no rule of law that the importation of a limited company into a relationship such as existed in this case prevents the continuation of a contract of employment. If the true relationship is that of

²⁵² Ibid at 281 Supra 238 at 235.

²⁵³ Ibid at 281 Supra 238 at 235 footnote 46.

²⁵⁴ Supra 206.

²⁵⁵ Supra 206 at 332-333.

²⁵⁶ One must note that this case is however distinguishable from the usual piercing case on the facts where a member tries to rely on the separate personality of the company but is prevented from doing so due to his misconduct. Supra 238 at 230.

²⁵⁷ Supra 6 at 144.

²⁵⁸ Ibid at 144.

²⁵⁹ *Catamaran Cruisers Ltd v Williams and Others* [1994] I.R. 386

employer and employee, it cannot be changed by putting a different label upon it.”²⁶⁰

An important decision is the Louisiana Supreme Court decision, *Glazer v Commission on Ethics for Public Employees*²⁶¹. In this case, the court held that the veil may be pierced by a balancing of “the policies behind recognition of a separate corporate existence” with the “policies justifying the piercing.”²⁶² Thus, there is a balancing of the competing policy considerations to determine whether the veil of incorporation should be pierced or not. This decision was a radical change from the past decisions of that court.²⁶³ Dennis J stated that the balancing approach would result in the separate personality of the company being maintained in some instances, whilst in other situations it would be discarded.²⁶⁴ The court distinguished the situation at hand from the situation where a company waives its right to separate legal personality. The court held that if there is a waiver of this right, then the veil should be pierced. The court noted that there is strong policy in favour of limited liability. Thus limited liability will be protected unless there is evidence of waiver. Evidence would be the company’s own disregard of the corporate form or by the company using the corporate form to commit a fraud.²⁶⁵

In the case *United States v Milwaukee Refrigerator Transit*²⁶⁶, the court held that the separate personality of a company would be disregarded where “the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime.” It is thus clear from the *Milwaukee Refrigerator Transit* case that American Courts have also made use of a categorisation approach when deciding whether or not the limited liability of the company will be disregarded.²⁶⁷

²⁶⁰ Supra 261 at 388.

²⁶¹ *Glazer v Commission on Ethics for Public Employees* 431 So 2d 752 (La 1983).

²⁶² Supra 263 at 757.

²⁶³ Supra 238 at 232.

²⁶⁴ Supra 263 at 757-758.

²⁶⁵ Supra 238 at 234.

²⁶⁶ *United States v Milwaukee Refrigerator Transit* (1905) 142 Fed 247 at 255 (ED Wis 1905). Referenced from *Ibid* at 232.

²⁶⁷ *Ibid* at 232.

5.11.1 **Alternative Tests**

In order to determine when the corporate veil should be pierced, the three-pronged instrumentality doctrine and undue domination tests have been suggested.

5.11.1.1 **Three-pronged instrumentality doctrine**

The three-pronged instrumentality doctrine is a test wherein the plaintiff is required to show various factors before the courts will reject the separate legal personality of the company. Firstly, it must be shown that the defendant had control of the company, which control was so complete that it resulted in total domination of policy, finance and business practices such that the company had no mind of its own. Secondly, it must be shown that this control was used to commit a fraud or a wrong which violated the plaintiff's rights, and thirdly that the control and breach of the duty that was owed to the plaintiff was a cause of the plaintiff's injury.²⁶⁸ This test indicates that control on its own will not suffice.²⁶⁹

5.11.1.2 **Undue Domination**

A test which has been used by the Virginia courts, requires the court to look firstly at whether there is "undue domination and control of the company by the defendant" and secondly, whether "the corporation was a devise or "sham" used to disguise wrongs, perpetuate fraud, or conceal crime."²⁷⁰ This test requires intentional misconduct by the defendant member.

It is noteworthy that none of these tests create clear-cut standards. All that remains is a list of factors which one must measure against the facts of the case at hand.²⁷¹ From the above discussion, it is evident that South Africa is not alone.

²⁶⁸ Bainbridge, *Abolishing LLC Veil Piercing*, University of California May 2004.<http://Papers.ssrn.com/so13/papers.cfm?> at 105. See American case, *Zaist v Olson* 227 A 2d 552, 558 (Conn 1967).

²⁶⁹ Bainbridge notes that the courts have in fact been sloppy in applying this test. *Supra* 25 at 508.

²⁷⁰ Quoted from *Supra* 25 at 509.

²⁷¹ *Supra* 25 at 509.

Foreign jurisdictions such as the United Kingdom and the United States of America have the same inherent problems with the intricacies of the doctrine. Since these problems are not unique to South Africa, it is apparent that the difficulties cannot be blamed on the South African judiciary, but rather are inherent to the doctrine itself.

6. **The pros and cons of veil piercing as a doctrine.**

The veil piercing doctrine allows the courts to thrust upon the members of companies unlimited liability. It is questionable as to whether veil piercing is equitable, having regard to the fact that the legal doctrine is uncertain in the case law.²⁷²

The doctrine is required to identify risks that have been externalised, but also has the task of differentiating those risks which a member should not be entitled to externalise. Thus, the law is required to take into account various considerations such as compensation of victims of corporate wrong doings, capital formation, economic growth and can even go as far as including economic democracy.²⁷³ This is no easy task and it may be argued that the veil piercing doctrine currently fails to meet these requirements.

The standard argument in favour of veil piercing is that it serves as a safety valve, as it allows for the courts to deal with cases where limited liability and the externalities associated with it are excessive.²⁷⁴

It is commonly accepted that limited liability can create negative externalities. Limited liability allows for companies to externalise part of their risk and costs that are incurred in the course of business, which are passed onto the constituencies and, one could go as far as to say, onto society at large.²⁷⁵ It is therefore evident that there is a need to protect those who deal with the company²⁷⁶ Thus, the veil can be pierced when the policies behind the presumption of corporate independence and limited liability are outweighed by policy justifications for disregarding the corporate form. .²⁷⁷

²⁷² Supra 270 at 102. See footnote XIV.

²⁷³ Supra 25 at 506.

²⁷⁴ Supra 270 at 101.

²⁷⁵ Supra 270 at 107.

²⁷⁶ Quoted from Ibid 107.

²⁷⁷ Ibid 107.

If one were to maintain the distinction of the separate personality of the company at all times, certain unjust circumstances could arise from this immunity. This shelter from liability would protect those who failed to operate the company as a separate entity. Thus, for those who do not respect the formalities of the law and ignore the applicable restrictions, it is useful (and indeed beneficial) for the courts to be able to pierce the corporate veil and impute liability where it belongs.²⁷⁸

It is evident that veil piercing may be of use, and that the reason for its existence can be argued to be a rational one, being to protect innocent parties (particularly in instances of fraudulent conduct by the company's members). This is not to say that the doctrine is not without fault. It has been argued by Bainbridge as well as other commentators, that the doctrine has some flaws which go to the very core of the doctrine. Some academics are of the view that the doctrine needs to be reformed, whilst others take a much more extreme view and advocate for the abolishment of the doctrine.

Although the courts have increasingly tried to define the approaches as to when the veil can be pierced²⁷⁹, the potential personal liability that may arise can be argued to be open ended. Hawke notes that the courts' intervention is impossible to rationalise given that the intervention is not backed by any coherent principle. According to Hawke, the lack of a coherent principle can be explained if one can appreciate that the removal of the corporate veil "could produce an order of the court requiring a regulatory disclosure at one end of the scale and an award of substantial damages in [delict] at the other."

Veil piercing can give rise to various legal consequences. Accordingly, facts that will justify piercing the corporate veil will depend upon the consequence sought. Where what is sought is the drastic remedy of holding the members liable for the debts of the company or the imposition on the company of an obligation incurred by its members, then the facts that are considered by the courts will not necessarily be the same as those that will justify the veil to be pierced where other consequences are sought.²⁸⁰ It would seem that the courts would in each case take different facts into account. Different judges might find different facts to be relevant, which may have an effect on the outcome of the decision.

One of the intrinsic flaws to the veil piercing doctrine is that there is no clear standard as to when the courts will pierce the corporate veil. It is noteworthy, in this regard, that the veil piercing doctrine is highly fact specific. The successes of some cases over others vary only

²⁷⁸ Ibid 107.

²⁷⁹ See "categorization approach" above.

²⁸⁰ Supra 86 at para 44.

in degree and not in kind.²⁸¹ Thus, this area of law can be regarded as being unpredictable, random and ambiguous.²⁸²

This is evident in *Gilford Motors*²⁸³ and *Die Dros*²⁸⁴ cases. In the *Die Dros* case, the court would not uphold the restraint of trade based on a lack of evidence, whilst the court in *Gilford Motors* did.

Another area in which the inconsistencies are evident is in the foreign position in the area of leasehold arrangements. The courts have said, in some instances, that they have sufficient power to pierce the veil in order to identify the continued identity of the occupant.²⁸⁵ Other authorities have, however, indicated that the courts are unwilling to provide that the corporate vehicles are shams and that the use of companies in leasehold arrangements indicate the true commercial intention of the parties.²⁸⁶

The very purpose of corporate law is to establish certainty and predictability. The Companies Act is very clear in this regard and indicates exactly which requirements are to be complied with for a company to be incorporated. These procedures are, however, time consuming and costly. As such, it is necessary to ask why members would follow the strict requirements in the Companies Act if they still run the risk of losing their limited liability status. This lack of certainty imposes a substantial cost.²⁸⁷

Veil piercing has real costs. Investors at incorporation are denied certainty and predictability. Some investors will over invest in expensive precautions, whilst others will under-invest in insurance and risk reduction. As regards investors after incorporation, the vague veil piercing standards lead to expensive litigation and not infrequently erroneous results.²⁸⁸ However, the social cost of legal rules is not only the costs they impose on the parties themselves, but also on the costs which the legal system will incur in enforcing the rules.²⁸⁹

Accordingly, the lack of predictability in court decisions is amongst the greatest deterrent to litigation being pursued. Injured persons will not litigate pressing issues, as they are unable to confidently predict the cost or the outcome. This is due to the expensive litigation fees

²⁸¹ Supra 25 at 506-7.

²⁸² Supra 25 at 506.

²⁸³ Supra 163.

²⁸⁴ Supra 199.

²⁸⁵ See *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd* [1985] 1 W.L.R., 173.

²⁸⁶ See *Kaye* [1991] E.G.L.R. 97 and *Hilton v Plustitle Ltd and Another* [1988] 3 ALL E.R. 1051.

²⁸⁷ Supra 25 at 514.

²⁸⁸ Supra 270 at 110.

²⁸⁹ Supra 25 at 524.

and the possibly erroneous results. As such, parties may be deterred from engaging in socially desirable activities or, at the least, will take excessive precautions.²⁹⁰ According to Bainbridge, veil piercing achieves, "neither fairness nor efficiency, but rather only uncertainty and lack of predictability, increasing transaction costs for small businesses."²⁹¹

Due to the doctrine's vague standards, judges have little guidance in terms of precedent and a wide discretion in deciding whether or not to pierce the veil. As a result, judges concern themselves with the specific facts at hand and are thus more concerned with the equities in question as opposed to the implications it would have on members' liability and society at large.²⁹²

Determining whether limited liability should be available to a company depends on a case-by-case analysis. This results in the courts having to balance competing policy decisions. The courts must encourage businesses to internalise the costs to society of their activities, whilst at the same time the courts wish to avoid impeding capital formation and economic growth. Balancing these concerns requires economic analysis. The problem here is that the courts have no staff economists to assist them with this analysis, resulting in additional expense to litigants seeking to pierce the corporate veil (who are thus required to hire their own economic experts).²⁹³

When judges are left to decide on their own, it is unlikely that they will be capable of striking the correct balance. This is not a personal attack on judges but rather the circumstance under which judges are expected to work. Thus the problem lies with the judicial system and not judges per se. Like anyone else, judges make mistakes. Further, judges work under massive time constraints. Due to these constraints, judges have an incentive to minimise effort. Judges are also not experts in every area of the law and are not all interested in developing their expertise in specific areas of law.²⁹⁴ Judges therefore might decide these cases with minimum effort.²⁹⁵ Whilst true in the majority of jurisdictions around the world, the above issues are particularly relevant in the South African context due largely to our under resourced judicial system.

A further problem is that most of the factors considered by the courts are unrelated to the policy concerns which are present in limited liability.²⁹⁶ The courts fail to give any general

²⁹⁰ Supra 25 at 514. See footnote 167.

²⁹¹ Supra 270 at 101.

²⁹² Supra 25 at 514.

²⁹³ Supra 270 at 108.

²⁹⁴ Ibid 108.

²⁹⁵ Ibid 108.

²⁹⁶ Supra 25 at 510.

guidance as to how the factors should be weighted or balanced.²⁹⁷ According to Thompson's²⁹⁸ findings, the most commonly cited reasons for the courts piercing the corporate veil were mere conclusory statements such as "control", "alter ego" and "sham" companies.²⁹⁹ Those who are in favour of tidy doctrines with easy application will not be in favour of veil piercing being part of our law, as judicial opinions in this area are vague. These decisions give us very little assistance in understanding the doctrine or when it will be invoked. Some argue that veil piercing offers judges short cuts and allows for judge to dispose of the case summarily without dealing with all of the complexities relating to the case law at hand or the doctrine."³⁰⁰

Due to the current state of the manner in which veil piercing is dealt with, judges are able to impose their own ideas of justice without needing to be concerned with precedent or appeals against or reviews of their decisions. When judges rely on short cuts, the result is often skewed and results in a mediocre doctrine. The courts seem to rely on various factors to make a decision even though it is seldom that they understand why the factors are of importance.³⁰¹ Courts seem to have a vague, intuitive sense of what amounts to a fair outcome, but which they cannot easily articulate. As a result, courts fall back on vague labels such as 'alter ego', 'lack of separation' which results in the conclusory announcements referred to above³⁰². Thus, instead of reasoned analysis, courts rely on vague labels.

Larkin and Cassim are of the view that the courts, "are... feeling their way in the dark."³⁰³ This, they say, is because the courts are relying on instinct rather than on principle. Although judicial instinct is often correct, judicial instinct alone this is not enough. In both *Cape Pacific* and *Hulse-Reutter*, one can argue on principle that the correct decision was indeed reached, but both decisions would have been better approached along the lines of principle.³⁰⁴

The questions that judges ask when piercing the corporate veil are not always the correct ones. This can result in the decision-maker looking at the side issues.³⁰⁵ Even if veil piercing is abolished, the judiciary will not be able to avoid these tough and difficult issues. The judiciary would have to refocus its judicial analysis on the relevant questions.

²⁹⁷ Ibid at 510.

²⁹⁸ Supra 224.

²⁹⁹ Supra 25 at 513. This is to name but a few of the terms the courts have used when deciding to pierce the veil.

³⁰⁰ Supra 25 at 523.

³⁰¹ Supra 270 at 109.

³⁰² Supra 25 at 514.

³⁰³ Supra 138 at 517.

³⁰⁴ Supra 25 at 517.

³⁰⁵ Supra 25 at 519.

According to Bainbridge, these questions should be “did the defendant-member do anything for which he should be held directly liable? Did the member commit fraud, which lead a creditor to forgo contractual protection? Did the member use fraudulent transfers or insider preferences to siphon funds out of their corporation?”³⁰⁶ These questions are more likely to lead to an optimal outcome.

Veil piercing has been argued to function as a tax on entrepreneurs or as a trap for the unwary. Members who can afford competent attorneys will spend time, effort and resources to ensure that their business operations are conducted in a way that will limit their veil piercing exposure.³⁰⁷ These are the people to whom veil piercing will be a tax (for the benefit of such legal advice). Those with insufficient funds for adequate legal advices will be trapped by veil piercing, without there being any regard by the courts to whether their conduct is really culpable or socially undesirable.³⁰⁸

Some argue that the objectives of the veil piercing doctrine are unobtainable, as it is called upon to attain lofty goals, such as leading members to internalise risk while simultaneously not deterring capital formation and economic growth, all the while still promoting the populist notions of economic democracy.³⁰⁹ However, there seems to be no evidence to indicate that veil piercing will cause claimants to internalise risk.³¹⁰ It can be further argued that the doctrine of veil piercing focuses on irrelevancies and not on whether claimants used their control to externalise risk. What is clear, however, is that courts will not pierce the veil whenever the defendant has externalised some cost onto third parties.³¹¹

It is argued that veil piercing does not address the problems of negative externalities. This is evident from the fact that our law of veil piercing is very vague³¹² and the application of the doctrine is unpredictable. Bainbridge argues that equity investors can protect themselves against personal liability in the case of veil piercing by using modest levels of capital or insurance. The problem here is that, with such a dysfunctional doctrine, the likelihood of it creating incentives for companies to optimally internalise the social costs of their business activities is not very high³¹³.

A means of protection for the voluntary creditor is for them to request that the members of the company sign personal surety for the debts of the company. If the creditor does not do

³⁰⁶ Supra 25 at 535.

³⁰⁷ Ibid at 535.

³⁰⁸ Ibid at 535.

³⁰⁹ Supra 270 at 101.

³¹⁰ Supra 270 at 107.

³¹¹ Supra 270 at 107-108.

³¹² Supra 270 at 108.

this, there should be no reason as to why the creditor should get a second chance by requesting that the courts pierce the veil so as to enable the creditor to reach the personal assets of the members. Thus, there are no externalities with respect to parties who voluntarily contract with a company. This should, of course, be limited to instances of misrepresentation.³¹⁴

7. **Alternative suggestions to veil piercing**

7.1 **Abolishing the doctrine**

It is also necessary to consider the implications of the abolishment of the veil piercing doctrine on the negative externalities created by limited liability, in the event that limited liability is retained.

It is argued that companies would have a license to externalise risk. This is, however, regarded as a highly unlikely outcome, as market forces would constrain the ability of companies to do so.

A second argument is that companies can externalise their business risks through personal misconduct. However, this remains sanctioned under a number of legal regimes.³¹⁵ In many of the veil piercing cases, the plaintiff could have brought a direct action against the member, as the defendant had acted in a manner that misled the creditor. In other cases, the defendant could be a joint party. With the corporate defendant, one could even impose vicarious liability.³¹⁶ Bainbridge is of the view that, “because the examples capture the cases in which limited liability seems most problematic (namely misrepresentation in connection with contract claims and deliberate externalisation of unreasonable risks in delictual cases), abolishing veil piercing would not leave deserving creditors without a remedy.”³¹⁷

The veil piercing doctrine, according to Bainbridge, could be refocused in order to eliminate irrelevancies and could be tied more closely to the policy purposes it is intended to effectuate³¹⁸ However, he is of the view that veil piercing should not be reformed but rather abolished. He argues that it is unlikely that reform can be

³¹³ Ibid at 108.

³¹⁴ Ibid at 108.

³¹⁵ Supra 270 at 109.

³¹⁶ Ibid at 109.

³¹⁷ Ibid at 109.

expected to produce any significant improvements to the situation at hand.³¹⁹ The abolishment of the doctrine would force courts to redirect judicial incentives towards the correct solutions to the problems.³²⁰

Bainbridge says that there are two major problems with veil piercing. Firstly, it allows for occasional judicial error. Courts may reach incorrect outcomes as a result of the doctrine being flawed. If veil piercing were abolished, it would force courts to use other doctrines and principles of law that go more directly to the issue at hand.³²¹ Secondly, even if all the decisions involving veil piercing have the correct outcome, there is still a cost. This is due to the marginal effect of the doctrine on the small business owners.³²² In this regard, the veil piercing doctrine forces entrepreneurs to focus on spending time and effort on organisational formalities. This does not address the real problem of negative externalities.³²³

The organisational formality aspect of veil piercing can encourage small companies to hire information processors, as well as reputational intermediaries, like lawyers and accountants. This could assist in improving the quality of disclosure of such small companies. Notwithstanding this, it is difficult to see how this would assist involuntary creditors as, for example, there is no comfort for a delict creditor or victim in knowing that the company's books and records are in good order.³²⁴

Voluntary creditors can demand certain organisational formalities and can bargain for the compliance.³²⁵ The problem with this argument is that it is difficult to find the evidence that the creditor wanted compliance with the organisational formalities with which veil piercing is concerned. Secondly, even if compliance were the majoritarian default, the fact that veil piercing is so rare and unpredictable makes it an odd choice for a means to achieve such compliance.³²⁶

There is thus no disputing that the veil piercing doctrine is inefficient and does not adequately meet its expectations. Yet the doctrine remains part of our company law, in light of the fact that the doctrine of separate legal personality (to which the

³¹⁸ Supra 270 at 108.

³¹⁹ Supra 270 at 109.

³²⁰ Ibid at 109.

³²¹ Supra 270 at 110.

³²² Ibid at 110.

³²³ Ibid at 110 Some academics are of the view that veil piecing by focusing on organisational formalities is an information forcing default rule. See Larry Ribstein, <http://busmovies.typepad.com/ideoblog/2002/02/welcome-to-unco.html>.

³²⁴ Ibid at 110.

³²⁵ Ibid at 110. "Some may claim that most creditors would bargain for such protections. As such veil piercing emerges as a majoritarian default."

³²⁶ Ibid at 110.

veil piercing doctrine is inextricably tied) is indispensable in a corporate law regime. The question is whether veil piercing is the best solution to solving the problem of fraudulent businessmen. This does not seem to be the case, as there appear to be some viable solutions, each of which has less of a negative impact than the imprecise doctrine of veil piercing.

7.2 **Alternative suggestions to the veil piercing doctrine**

In order to obtain historic perspective, it is necessary to bear in mind that the courts began to accept the veil piercing doctrine for the first time in only the 1980's. Prior to this, there were a host of cases which quietly managed to deal both realistically and satisfactorily with the often very difficult problems of the separate entity principle, without having to employ the principle of veil piercing. The cases that did make reference to the doctrine were generally rather vague.³²⁷ This is a clear indication that there are alternative exceptions to the separate personality rule, other than the veil piercing doctrine. It has been argued that the veil piercing doctrine is in fact a false trail for our law to follow and that there is no reason as to why the courts cannot deal with the difficulties of limited liability without having to make use of the doctrine of veil piercing.³²⁸

7.3 **Alternative Reasoning with the Same Outcome**

It is submitted that the vast majority of the cases dealing with the doctrine of veil piercing could have had the same outcome, but with different, more justifiable, reasoning (as an alternative to applying the difficult doctrine of veil piercing).

In *Cape Pacific*, the court looked at control and stated³²⁹ at all material times [the controller] personally exercised control over the shares as effectively and completely as if they belonged to him personally. In relation to its dealings with the shares, the seller was more than just [the controller's] puppet; it was effectively none other than [the controller] personally, albeit in a different guise.³³⁰ Larkin and Cassim argue that the courts seem to be saying that the company was merely the agent of the controller. If this is in fact the case, there would be no problem in the company calling the controller (the member) to assist in performing the court

³²⁷ Supra 5 at 277-278. See footnote 5.

³²⁸ Supra 150 at 490.

³²⁹ Supra 95 at 799 C-D.

³³⁰ Supra 138 at 518.

order.³³¹ An argument in the alternative would be that the company has the right to call upon the controller as well as a third party to assist with it performing the court order owing to the fact that there had been bad faith.³³² Accordingly, on either approach, the controller could have been called upon to meet the claim against the company.³³³

In *Tor Industries (Pty) Ltd v Gee - Six Superweld CC*³³⁴, the central issue revolved around a one line contract where a foreign company had agreed, in favour of a South African company, that it would not sell its products to anyone in South Africa other than the South African company. The question at hand was whether the subsidiary of the foreign company was also bound by the contract. The court stated that, if it could be shown that the foreign company was misusing its subsidiary to perpetuate a fraud, or that the subsidiary was being used for a dishonest or improper purpose to subvert the South African company's rights, the court would pierce the veil and disregard the separate juristic personality of the subsidiary company from that of the holding company in order to uphold the South African company's rights.³³⁵ However, the court held that no such case could be made out on the facts in question.³³⁶ In this case, the court seems to have reached the correct decision. However, the decision could certainly have been arrived at in a different manner. The contract could have been interpreted more searchingly, or the court could have added a tacit term to it. This would have allowed the court to determine whether the actions by the subsidiary were really beyond the reach of the contract.³³⁷ On this basis, it would be surprising if it was (and, even of this basis, the court appears to have reached the correct decision). It would be equally surprising if, when one was looking at the actions of the subsidiary and comparing the actions that were and were not beyond the ambit of the contract, the business relationship between the holding company and the subsidiary was not decisive in the court's determination³³⁸ The court in *Tor* saw this very clearly.

If one applies general contractual principles and finds that the actions of the subsidiary were in fact not covered by the contract, then it would be very hard to see how the holding company committed a fraud by using its subsidiary to subvert the

³³¹ Ibid at 518.

³³² Ibid at 518.

³³³ Ibid at 518.

³³⁴ *Tor Industries(Pty) Ltd v Gee - Six Superweld* CC 2001 (2) SA 146 (W).

³³⁵ Ibid at 157 D, quoted from *Supra* 138 at 518.

³³⁶ Ibid at 157 D.

³³⁷ *Supra* 138 at 518.

³³⁸ *Supra* 138 at 519.

rights of the South African company.³³⁹ However, the decision of the court in the *Hulse-Reutter* case appears to require that there be no remedy in contract before a court can pierce the corporate veil.³⁴⁰

*Airlink Pilots Association SA v SA Airlines*³⁴¹ was decided before the *Hulse-Reutter* decision was handed down. Here the court regarded the question of who was the real decision-maker³⁴² as being more important than the question of who was the real employer.³⁴³ The court held that the decisions emanated from the holding company. This was “a device to change the terms and the conditions of the employment relationship between [the holding company and the pilots].”³⁴⁴ The court held accordingly that the commercial relationship between the two companies should be disregarded and the corporate veil pierced.³⁴⁵ The question that needs to be addressed is whether it was indeed necessary to pierce the veil in this case. An alternative approach has been suggested, namely that the court should have examined whether the subsidiary was merely the agent of the holding company.³⁴⁶ If this had been the approach, the important question would have been not who was making the decision, but rather for whom the decision was being made. The question in this analysis is whether the holding company was in fact acting on its own behalf, with the subsidiary acting as its agent, or if the holding company was acting on behalf of the subsidiary, with the subsidiary as principal. This approach is very similar to the approach taken by the court. However, since the court based its decision on the doctrine of veil piercing, the decision lacked analytical clarity.³⁴⁷

The facts indicate that the courts were concerned with the holding company acting as the agent of the subsidiary. It is thus submitted that the answer ought in fact to have been found in contractual principles, rather than the doctrine of veil piercing (would was unnecessary and gave rise to difficulties in application).³⁴⁸

In *Commissioner, South African Revenue Service v Professional Contract Administration*³⁴⁹, the court equated the doctrine of veil piercing to the doctrine of

³³⁹ Supra 336 at 157 D.

³⁴⁰ Supra 138 at 519.

³⁴¹ *Airlink Pilots Association SA v SA Airlines* (Pty) Ltd [2001] 6 BLLR 587 (LC).

³⁴² Supra 343 at para 27.

³⁴³ Supra 138 at 519.

³⁴⁴ Quoted from Supra 138 at 519. Supra 343 at para 41.

³⁴⁵ Supra 343 at para 43.

³⁴⁶ Supra 138 at 520.

³⁴⁷ *Ibid* at 520.

³⁴⁸ *Ibid* at 520.

³⁴⁹ *Commissioner, South African Revenue Service v Professional Contract Administration* CC 2002 (1) SA 179 (T).

substance over form.³⁵⁰ Accordingly, it is arguable that one is required merely to look at the substance of a relationship between a company and its members rather than its mere form. It is argued by Larkin and Cassim that, if the test is substance over form, there is no need to automatically pierce the veil.³⁵¹

These few examples are clearly illustrative that, in the vast majority of cases, veil piercing is not the only option open to the court and is not the only way in which a plaintiff can receive relief. Thus, if the courts expand their thinking to alternative applications of general commercial legal principles, there may be no need to rely strictly on piercing the corporate veil (which, as stated above, is difficult to apply).

7.4 **The separate entity theory**

Other theories have emerged as to the manner in which abuse of the corporate form should be managed without the corporate veil having to be pierced. Larkin states that it is no surprise that veil-piercing cases are so hard to find, as veil piercing does not really exist. According to Larkin, the separate entity theory is a solution which is capable of dealing with the entity in all of its facets, and which escapes the problems of vagueness which are prominent in the veil piercing doctrine.³⁵²

Larkin argues that one cannot sacrifice the entity construction. To do so, he says, will be to re-write the law. He goes even further and states that to sacrifice the entity in favour of equity will frustrate the law and goes against everything that it is trying to achieve. There is nothing in the law which gives effect to the reversing of the entity status, nor anything that would be sufficiently compelling for one to argue for the law to be interpreted in such a manner.³⁵³

Larkin argues that an approach is needed which will result in being able to reach those individual members of the company that need to be reached.³⁵⁴ This approach requires sensitivity, so that one can link the reason for looking from the company to the members which, he says, is not achieved by the veil piercing doctrine.

³⁵⁰ Supra 351 at 190 B-C.

³⁵¹ Larkin and Cassim, *Company Law, The Annual Survey of South African Law* 2002, Juta 635 at 635.

³⁵² Supra 5 at 297.

³⁵³ Supra 5 at 282.

³⁵⁴ Supra 5 at 283.

Larkin further argues that the entity must remain unharmed. The company is an entity that is to remain separate from the members. In terms of a strict entity theory, the entity (as a separate person) may be of absolutely no significance. The relevance will depend upon the legal issue which is under consideration. These legal issues can be contractual, statutory in nature or based on common law. The legal issue must always be approached properly. Larkin states that “[o]nly if it is, and properly understood, is it then applied in the company situation, and the proper answer on whether to focus on the company emerge.”³⁵⁵ The problem that arises is that people disagree as to what the correct approaches to these legal issues are. This problem transcends the problem of the corporate veil.

Larkin says that what has been mistaken as piercing the corporate veil should rather be seen as the battle between substance and form.³⁵⁶ Difficulties can arise and are due to the fact that the company is *sui generis*, whilst the principles in statute, contract and common law are formed around traditional categories. Carefully drafted contracts and legislation could cater for it, but the problem lies in the common law. He says that “the concrete forms are unlikely to be made adequate in the foreseeable future. In the interim, substance will enjoy form’s discomfort and, when this discomfort becomes intolerable, will enjoy many a victory, at the expense of form.”³⁵⁷

Although unacceptable results may arise, Larkin notes that there are ways to avoid these. Firstly, the legal rule being applied must be properly understood. Secondly, the separate entity cannot be applied like a blunt instrument which causes results which no one can defend. He notes that, instead, what needs to be remembered is that the company exists to facilitate and encourage business enterprises.

Perhaps the courts ought to approach corporate form abuses in this manner as this would avoid the courts having to look for a category into which all of the facts will fit, or having to balance various policy considerations. The principle will, it is submitted, result in greater judicial accuracy as well as more predictable results.

³⁵⁵ Supra 5 at 290.

³⁵⁶ Ibid at 290.

³⁵⁷ Supra 5 at 291.

7.5 Piercing the veil when there are other remedies readily available

In *Cape Pacific*, Smalberg JA stated that³⁵⁸ “I see no reason why piercing of the corporate veil should necessarily be precluded if another remedy exists. As a general rule, if a person has more than one legal remedy at his disposal, he can select one rather than another... the existence of another remedy or the failure to pursue one that was available, may be a relevant factor when policy considerations come into play, but it cannot be of overriding importance.”³⁵⁹

Blackman³⁶⁰ is, however, of the view that the courts can only pierce the veil when there are no other remedies available to the plaintiff. He suggests that the departure in the *Salomon* case should be permitted to a plaintiff only when the plaintiff has no alternative remedies and, accordingly, will suffer a major injustice if the veil is not pierced.³⁶¹

Piercing the veil should never be used simply as an alternative remedy, where on exactly the same facts, another remedy is available that would have the same consequence for the plaintiff. This is because all alternative remedies assume what an order obtained through veil piercing does not, namely the existence of the company as a separate entity. If an alternative remedy were available and the courts could avoid piercing the veil, then the plaintiff would not suffer a prejudice if the veil were not pierced. Accordingly, veil piercing would not be justified and the separate existence of the companies would not be undermined.³⁶²

Based on the dictum in *Cape Pacific*³⁶³ it was argued in *Hulse-Reutter* that the existence of other remedies against the company does not preclude a remedy against the members for any fraud committed by them.³⁶⁴

The court’s response in *Hulse-Reutter* to *Cape Pacific* was, firstly, that the court in *Cape Pacific* did not state that the existence of another remedy was irrelevant and, secondly, that one must look at the dictum in its context. In this regard, the court stated that the facts were in this case very different to those in *Cape Pacific*.³⁶⁵ In *Hulse-Reutter*, the respondent’s contractual rights were enforceable in the first

³⁵⁸ Supra 95 at 805.

³⁵⁹ It is important to note that this was said in obiter.

³⁶⁰ Supra 86 at para 43.

³⁶¹ Ibid at para 43, footnote 2.

³⁶² Ibid at para 43, footnote 2.

³⁶³ Supra 95 at 805 G.

³⁶⁴ Supra 138 at 515.

instance against the company. The court said that the very exceptional nature of the relief which the respondent sought against the member requires that there be no other remedies available. The fact that the company would be unable to pay the debt if it was sued is fatal to the respondent's case.³⁶⁶ Thus, the court seemed to disagree with the decision in *Cape Pacific* by providing that if other remedies are available, then a plaintiff cannot make use of the veil piercing doctrine.

It should be noted that the rights in *Cape Pacific* were also rights of first instance. As such, even though the remedy had prescribed, it would have made no difference. Any claim can prescribe and there is no reason as to why the law of prescription should not apply to the doctrine of piercing the corporate veil, as it would be applied in any other area of law.³⁶⁷ As such, it does not seem possible to distinguish *Cape Pacific* in the way that the court did.³⁶⁸ Larkin and Cassim note that it is not surprising as to why the two cases differ on this issue. The reason for this is that the cases also differ as to what requirements must be met for an "unfair advantage".³⁶⁹

The above inconsistency illustrates again how confused and unpredictable this area of law is, even with regard to the simple issue of being able to argue in favour of veil piercing in the alternative. An interesting issue to consider is why a plaintiff would opt for a remedy of veil piercing when there is extensive case law, as well as academic literature, which indicates that the doctrine is confused and that the results of litigation are uncertain. This is evident by the two cases mentioned above. There is a high risk factor involved when a plaintiff decides to rely on veil piercing as their remedy. Other areas of the law (such as misrepresentation in contract law) are much more clearly defined. Accordingly, if the plaintiff has a strong case based on misrepresentation, it seems to be illogical as to why they would elect to rely on veil piercing as a remedy.

Most academics agree that veil piercing is an exceptional remedy as it undermines the very essence of the separate personality rule. Since the separate personality rule is important in any system of commercial law, common sense seems to indicate that, if there are other remedies available, the alternative remedies to veil piercing should be applied by the courts.

³⁶⁵ Supra 134 at para 23. Supra 138 at 516.

³⁶⁶ Supra 134 at para 23.

³⁶⁷ Supra 138 at 516-517.

³⁶⁸ Supra 138 at 517.

³⁶⁹ Ibid at 517.

7.6 “Agency”

“Agencies” can be described as where the company does not carry on its own business affairs or business interest, but rather acts in the furtherance of the affairs of the controlling members, resulting in the situation where the controlling members do not treat the company as a separate entity.³⁷⁰ Accordingly, the company is merely a conduit for the controlling members to carry on their own personal business, resulting in an abuse of the separateness of the company.³⁷¹

The company can act as the agent of its members if it is authorised to do so and, in such circumstances, the members will be bound by the acts of the company. In these instances, it is the members and not the company that will be liable in respect of any contract entered into by the company on their behalf, as their agent.³⁷² This flows from general agency principles, where the principle will be liable for the acts of the agent. Where a person or a company contracts as an agent, it is not the agent that assumes liability, but the person on whose behalf the agent is acting (the agreement reached will be the agreement of the principal). As such, the principal is the only person who can sue or be sued in terms of a contract of this nature.³⁷³

The courts can impute the liability of the company onto the members and can circumvent the issues that have arisen in relation to veil piercing by treating the company as the agent of the member. This results in the members being held liable for the acts of the agent (in this case, the company).³⁷⁴ The courts have, in certain cases, ignored the separate legal personality of the company based on the agency construction.³⁷⁵ Clearly, however, the agency principle cannot be applied in every case. The limited circumstances in which it can be utilised are where the members disregard the separate nature of the company and in fact utilise it as their agent.

Although there is case law that indicates that this is agency in the normal sense, Blackman is of the view that this is not the case. In this regard, Blackman has stated that “[t]his is not merely because the courts do not insist upon the existence of a contract of agency...in terms of which the company does act as an agent properly so called. It is because the company in question does not in truth ever

³⁷⁰ Supra 86 at para 46.

³⁷¹ Ibid at para 46.

³⁷² Ibid at para 46.

³⁷³ Supra 10 at 13. Agency has its roots in the Joint Stock Corporation and continues to have relevance to corporations particularly with regards to determining rights and obligations.

³⁷⁴ Supra 165 at 14.

conduct the business of an agent.”³⁷⁶ Accordingly, if the company did act as an agent, then it would be conducting its own business, that being the business of agents.³⁷⁷

It is not disputed that a person who controls a company can abuse the corporate form and use the company as its agent.³⁷⁸ As early as the *Salomon* case, the court held that the veil can be pierced in instances of “agency”. However, the courts are reluctant to determine that there was a relationship of agency and principle in existence and, in such a case, to pierce the veil.³⁷⁹ To escape the strict interpretation of the separate legal personality of the company, it is easier to rely on agency than to rely on the abuse of the corporate form, owing to the fact that the agency argument does not require any form of impropriety or fraudulent conduct (which must be present when piercing the corporate veil).³⁸⁰ Therefore, all of the advantages of separate legal personality are present, without actually treating company as a separate entity.³⁸¹ The agency construction has thus been argued to be a helpful instrument in to adapting legal principles to modern requirements.³⁸²

It was argued by Lord Denning that if control was present, it would be sufficient for the courts to pierce the veil on that basis. However, in *Re Tecnonion Investments Ltd*³⁸³ it was stated that control, on its own, was insufficient to give rise to the piercing of the corporate veil. Dillan CJ held that one must look at whether “in truth the company is the agent of the ... man”. It was also held that it is insufficient to consider if one man was the dominant figure. It was noted, in this regard, that practical problems may arise in this test, owing to the different standards imposed on the various types of corporate entities (for example a close corporation with a few dominant members, which has no ‘corporate ends’ separate from those of the owners). In recognition of this, the courts generally require plaintiffs to show something more than simple control over the corporate.³⁸⁴

³⁷⁵ Supra 23 at 306.

³⁷⁶ Supra 86 at para 46.

³⁷⁷ Supra 86 at para 46.

³⁷⁸ *Gramophones and Typewriters Ltd v Stanley* [1908] 2 KB 89 at 95-96.

³⁷⁹ Supra 125 at 296. This is particularly in instances where there are individual members. The court does seem more willing when it is concerned with group entities.

³⁸⁰ Supra 23 at 311.

³⁸¹ Supra 86 at para 46.

³⁸² Supra 23 at 309.

³⁸³ *Re Tecnonion Investments Ltd* 1985 BCLC 434 at 442 (CA).

³⁸⁴ Supra 270 at 104.

In *Wallersteiner v Moir (No 2)*³⁸⁵, the court accepted the agency construction and, in holding the member liable, held that “[the member] controlled their every movement. He pulled the strings...They were his agents to do as he commanded. He was the principle behind them.”

In *British Thompson-Houston Co Ltd v Sterling Accessories Ltd*³⁸⁶ the court held that, if there is an absence of proof, a company cannot be seen as the agent of those who are the sole directors and members, in order to impute personal liability upon them for delictual conduct.³⁸⁷ This decision was based on the *Salomon* case, in holding that agency of the company cannot be inferred from merely holding office as a director or by having control of the shares, but that one needs to establish agency substantively.³⁸⁸ It has been held that the establishment of agency could be done through an agency agreement and, it has been suggested, that if there is no express agreement, then agency will not be present.³⁸⁹ Hawke is of the view that this is too extreme.

In practice, however, the courts are willing to infer the existence of an agency relationship where the facts indicate that a company was incorporated with minimal capital and there is no place of business nor staff. In *Re FG (Films) Ltd*³⁹⁰ 90 percent of the company was American, but they wanted the film to be registered as British and not as American. The registration was refused as it was clearly an American film based on an agency relationship.³⁹¹

In the United States of America, the courts have been unwilling to articulate with clarity the circumstances as to when piercing the corporate veil is permitted, but in the instance of agency the courts will not only consider the controlling interest but also whether a company is under-capitalised, the degree of financial ownership, the degree of actual dominance of the affairs in practice, the failure to observe corporate formalities and the siphoning of funds.³⁹²

³⁸⁵ *Wallersteiner v Moir (No 2)* [1974] 1 W.L.R. 991 at 1013.

³⁸⁶ *British Thompson-Houston Co Ltd v Sterling Accessories Ltd* [1924] ALL E.R. 294.

³⁸⁷ *Supra* 6 at 150.

³⁸⁸ *Ibid* at 150.

³⁸⁹ *Ebbw Vale U.D.C. v South Wales Traffic Area Licensing Authority* [1951] 2 K.B 366 at 370.

³⁹⁰ *Re FG (Films) Ltd Ltd* [1953] I.W.L.R 483.

³⁹¹ *Supra* 6 at 150.

³⁹² *Supra* 125 at 300.

7.7 Insurance

If veil piercing is going to continue to be applied in the manner in which it has over the past two decades, then companies will have to take their own precautions to protect themselves. No member wants to find himself/herself in the situation where his/her limited liability status could be forsaken, potentially placing him/her in a situation where he/she is required to pay a defendant a large sum of money out of his/her personal estate. In order to protect themselves against such a situation, companies (and members) can take out insurance policies.

If insurance is available, it can result in limited liability losing much of its relevance, except where it is used to identify the person who is under pressure to secure the insurance.³⁹³ As a result, insurance has been seen as an alternative to limited liability.³⁹⁴ However, it is idealistic to expect that all companies will have total insurance coverage for all corporate risks in respect of which limited liability is externalised.³⁹⁵ Academics have stated that, if limited liability did not exist, companies would attempt to invent it through insurance (a close substitute).³⁹⁶ Limited liability is a shortcut to this and avoids the cost of separate transactions. In this light, limited liability appears to be compelling.³⁹⁷

It seems to be a common feature that when companies are being incorporated, liability insurance is taken. This indicates that there is uncertainty surrounding limited liability as a protective device,³⁹⁸ where there exists a fear of insolvency (especially in respect of risky ventures).³⁹⁹ Most companies choose a relatively low coverage limit as opposed to an upper limit on coverage, which suggests that incomplete insurance is a common strategy.⁴⁰⁰

One must note that creditors can also rely on personal guarantees in order to avoid having to rely on the application of limited liability in the event of business failure. Here, insurance may play a very important role in both the bargaining power between the company and the creditor, as well as part of the company's own strategy for commercial purposes.⁴⁰¹ Insurance will reduce, if not eliminate, the

³⁹³ Supra 6 at 121.

³⁹⁴ Supra 65 at 139. This being where insurance is available on appropriate terms.

³⁹⁵ Supra 6 at 121.

³⁹⁶ Ibid at 121 and Supra 28 at 47-48.

³⁹⁷ Supra 28 at 47-48.

³⁹⁸ Supra 6 at 122.

³⁹⁹ Ibid at 122.

⁴⁰⁰ Ibid at 122.

⁴⁰¹ Ibid at 122.

externalities which the company would otherwise be protected against through limited liability.⁴⁰² One cannot forget that there is another factor involved, namely the willingness to accept the terms of the insurance policy in question. It is up to the company to decide on the economic and financial advantages of investing in insurance.⁴⁰³

As mentioned before, veil piercing is unpredictable and not very often the subject of litigation. Thus, companies will need to balance on the one hand the risk of the company being incapable of satisfying a debt⁴⁰⁴, which could result in the members being liable in their personal capacity as well as the likelihood of the courts actually piercing the veil with, on the other hand, the willingness of the company to pay monthly premiums to an insurance company on the mere possibility that the veil might be pierced. This, as mentioned above, does not seem to be much of an incentive and the latter seems to outweigh the former.

Insurance of this kind appears to be an alternative to limited liability, and gives the members, the company and, in fact, the creditors, an alternative to piercing the corporate veil. In this regard, insurance would be sought to cover the amount of debt which the company cannot settle in the event of the veil being pierced, as opposed to members being held liable in their personal capacity. This argument is not without flaws, as the insurance company may stipulate that it will not honour the insurance policy in cases of fraud. Further, the perpetrators of the fraud may still be liable for criminal sanctions in such cases.

7.8 **Legislating to cure the problem – the solution?**

In the mid 1980's, the Close Corporation Act gave effect to the statutory version of the doctrine of veil piercing.⁴⁰⁵ Section 65 of the Close Corporation Act provides that, where there is a gross abuse of the juristic personality of the corporation as a separate entity, the court can deem the corporation not to be a juristic person in respect of such obligations, liabilities or rights, or of such member or members of the corporation, as are specified in its declaration.

⁴⁰² Ibid at 122.

⁴⁰³ Ibid at 122.

⁴⁰⁴ Please bear in mind that members being held liable to pay debts of the company is only one of the instances when the veil has been pierced other instance is restraints of trades.

⁴⁰⁵ The Close Corporation Act 69 of 1984 (the "Close Corporation Act"). Supra 5 at 280.

South Africa's Close Corporation Act is regarded as being one of the very best in modern thinking. Many of the issues in the Close Corporation Act are of relevance in company law and, accordingly, those issues included in the Close Corporation Act are often a good indication of what is to come in future versions of the Companies Act. Consequently, because veil piercing was seen as being necessary for inclusion into the Close Corporation Act, it can be argued that there is a strong possibility that similar provisions will be included into the Companies Act (specifically having regard to the fact that there is currently a process under way for a complete overhaul of the Companies Act, in which it is expected to appear a provision dealing with veil piercing in circumstances of abuse of juristic personality). Larkin is of the view that veil piercing has been given a huge amount of credibility by its inclusion in the Close Corporation Act⁴⁰⁶, and that this indicates that the veil piercing doctrine is here to stay.

Whilst having veil piercing included in statute provides for certain procedural advantages, as well as visibility of the doctrine, it also has its vices (in that the courts may adopt a formalistic, rigid approach by interpreting the provision in a very technical manner).⁴⁰⁷

In *National Director of Public Prosecutions v Phillips*⁴⁰⁸ the court held that it was unnecessary to pierce the corporate veil.⁴⁰⁹ The court stated that “only misuse or abuse of the principle of corporate personality warrants piercing the veil.”⁴¹⁰ Larkin and Cassim note that the difficulty with this test is determining what it actually means.⁴¹¹ This is, however, similar to the approach adopted in the Close Corporation Act. The concern with section 65 of the Close Corporation Act is that, although it gives the doctrine more force, the courts are still faced with the same troubling issues such as the requirements for an abuse that must be present. Thus, the same problems which the courts have faced with the fraud category will arise under the Close Corporations Act, bringing little additional clarity or predictability to the application of the doctrine.

If veil piercing is to be legislated in South Africa, then it appears to be useful to examine the position in the United States of America, in particular the Model Business Corporation Act Annotated which states that, “[u]nless otherwise provided

⁴⁰⁶ Ibid at 280.

⁴⁰⁷ Supra 5 at 280. See footnote 21.

⁴⁰⁸ *National Director of Public Prosecutions v Phillips* 2002 (4) SA 60 (W).

⁴⁰⁹ Supra 410 at para 81.

⁴¹⁰ *National Director of Public Prosecutions v Phillips* 2002 (4) SA 60 (W) at para 80.

in the articles of incorporation, a member of a company is not personally liable for the acts or debts of the company except that he may become personally liable by reason of his own acts or conducts.⁴¹² This, it is submitted, encapsulates limited liability, and the piercing of the corporate veil, as it should be. Thus, members can be held liable for their own misconduct. The question is thus not whether the members used the company as their “agent”, but rather whether the member himself/herself acted in such a manner that they should be held personally liable.⁴¹³

It has been suggested that this will alter the jurisprudence of the veil piercing doctrine, as it will result in the adoption of a single set of statutory standards as to when limited liability should be discarded. This will provide the necessary certainty in this area of law and will allow for uniformity when applying the veil piercing doctrine.⁴¹⁴ It will also create a consistent test that will eliminate free-form decision-making.⁴¹⁵

Accordingly, if this test is adopted, the loss of limited liability will result from the voluntary acts of the owner and therefore a member’s limited liability can be said to be waived by his/her actions.⁴¹⁶ The test will result in attorneys being able to advise their clients that dishonest conduct in the conducting of their business is the only way that a member can be held personally liable. If a business is conducted in an honest manner, one can be assured of the protection of statutory liability.⁴¹⁷ Limited liability would be lost to the member, for example, if he/she acts fraudulently, renders services for less than a reasonable equivalent value or distributes money or other property to the member who then renders the company insolvent.⁴¹⁸ The Model Business Corporation Act focuses on the behaviour of members that directly misleads creditors and where the member causes the entity to become insolvent.⁴¹⁹

The result of this test is rather significant, as it provides honest business owners with security because, if their affairs are conducted in an honest manner, they need not fear losing the protection of separate personality. At the same time, it prevents the fraudulent business owners from hiding behind the shield of limited liability⁴²⁰ and prevents them from making a mockery of the corner stone of our company law.

⁴¹¹ Supra 353 at 636.

⁴¹² 1 Model Business Corporation Act Annotated. S6.22 (b) (3d ed.Supp.1997).

⁴¹³ Supra 25 at 516.

⁴¹⁴ Supra 32 at 152.

⁴¹⁵ Ibid at 152.

⁴¹⁶ Ibid at 152.

⁴¹⁷ Ibid at 152.

⁴¹⁸ Ibid at 152.

⁴¹⁹ Supra 32 at 186.

It is thus suggested that this is, in all likelihood, the most appropriate solution to the problems with the veil piercing doctrine (as articulated in this paper).

Section 424 of the Companies Act in South Africa does not provide the above solution, as currently drafted, as only applies in circumstances where the member has carried on business with the intent to defraud creditors of the company or for any fraudulent purpose.

7.9 Conclusion

From the foregoing suggestions (ranging from the courts taking a different approach, legislation being created, the strict entity theory and insurance), it is apparent that veil piercing is not the only solution and that alternatives to veil piercing do exist. The most appropriate route that our legal system should, it is submitted, take is to legislate and impose liability upon a person for their own misconduct (as is the position in the United States of America). This will prevent the courts having to disrupt the very essence of our company law, that of the separate existence of the entity, while still being able to impose liability where it is due.

8. Conclusion

The doctrine of limited liability saw the introduction of the concept of the company as a separate legal entity, distinct from its members. Few will disagree that limited liability of members is a cornerstone of any body of company law (including in South Africa) and to a large degree dictates the manner in which companies operate. As has been discussed throughout this paper, the doctrine has various advantages and disadvantages. On the one hand, by ring-fencing the liability of the corporate entity in the corporate entity itself, the risk undertaken by members is effectively limited to their capital investment, thereby encouraging investment and, in turn, economic growth. This fosters a culture of entrepreneurship. On the other hand, however, limited liability transfers much of the risk of doing business to the counterparty and has been said to encourage reckless governance and risk taking by members, with various costs arising therefrom. *Ceteris paribus*, it would seem as though the advantages outweigh the disadvantages.

⁴²⁰ Supra 32 at 193.

While limited liability is well established in our legal system, it cannot be regarded as being absolute. An exception to limited liability is the doctrine of piercing the corporate veil, which effectively disregards limited liability and imputes liability for the company to its members in certain circumstances.

As has been discussed above, the doctrine of piercing the corporate veil is clearly in a desultory state. Notwithstanding an almost universal recognition that limited liability should not be allowed to flourish unchecked and that under certain circumstances veil piercing is justified and necessary, the veil piercing doctrine remains underdeveloped and fraught with uncertainty.

Decisions by our courts have been inconsistent and, because veil piercing cases are so highly fact specific, no concrete guidelines have been established as to when and how the veil may be pierced. A further problem is that the courts seem particularly focused on the “categorisation approach” in ascertaining whether or not to pierce the corporate veil in each particular case. A major problem arising from the implementation of the “categorisation approach” is that each of the categories have faults of their own. A further problem with the “categorisation approach” is that, where the facts of a particular case do not fit neatly within one of the existing categories, the court will be unable to pierce the veil. In addition, it has been argued that judges are ill equipped to deal with the intricacies of the suggested tests. The practical consequences of this, is that successful veil piercing claims tend to differ from unsuccessful claims, not only in degree but also in kind.⁴²¹

The veil piercing doctrine also remains underdeveloped in legislation. While certainty in respect of this doctrine could have been introduced by the legislature, our legislation has dealt with the veil piercing doctrine in a misguided manner and/or does not deal with this doctrine directly, allowing this area of law to fall within the domain of the judiciary (who, as mentioned above, have not dealt with it adequately).

As a consequence of the aforementioned legislative deficiency and judicial uncertainty, business owners have no guidance in ascertaining what will or will not result in a loss of limited liability⁴²² through the piercing of the corporate veil. This has, in many instances, resulted in non-desirable consequences and additional expenses. As such, it is no wonder that change in respect of this doctrine is desperately required.

⁴²¹ Supra 270 at 106.

⁴²² Supra 32 at 150.

With chaos like this, it is questionable why such a doctrine would remain in our company law, especially where it is evident from a host of cases and theories that similar relief can be provided through alternative remedies which do not undermine the principle of separate legal personality. It is thus submitted that the courts should change the current approach in order to create certainty, predictability and a more sound company law. It would appear though, for the time being at least, that the doctrine is here to stay.⁴²³ This is evident from the rigid *Hulse-Reutter* style approach that our judges now seem to be following.

Alternatively, our legislature can elect to follow the approach in the United States of America, where legislation dictates that misconduct on the part of members will give rise to personal liability in respect of that member. This, it is submitted, encapsulates limited liability, and the piercing of the corporate veil, as it should be. It has been suggested that this will alter the jurisprudence of the veil piercing doctrine, as it will result in the adoption of a single set of statutory standards as to when limited liability should be discarded. This will provide the necessary certainty in this area of law and will allow for uniformity when applying the veil piercing doctrine.⁴²⁴ It will also create a consistent test that will eliminate free-form decision-making.⁴²⁵ The result of this test is rather significant, as it provides honest business owners with security because, if their affairs are conducted in an honest manner, they need not fear losing the protection of separate personality. At the same time, it prevents the fraudulent business owners from hiding behind the shield of limited liability⁴²⁶.

Notwithstanding the regrettable *status quo* in respect of the veil piercing doctrine, it is clear from this paper that there is still potential to salvage this area of law. This will, however, require a change in policy by either the courts or the legislature. One can only hope that heed will be given to the sage advice of our learned academics, that the successes of other jurisdictions will be emulated and that alternative approaches affording similar relief will be adopted.

⁴²³ Supra 270 at 106.

⁴²⁴ Supra 32 at 152.

⁴²⁵ Ibid at 152.

⁴²⁶ Supra 32 at 193.

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