DISSERTATION

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Beyond the Corporate Veil - a commentary on the approach of the South African Courts to the question of lifting the corporate veil, with particular reference to a tax-avoidance based structure in common use in South Africa at this time.

R H PERRINS

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University of Cape Town

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1. INTRODUCTION

> "The Court of Appeal has declared that the formation of the respondent company and the agreement to take over the business of the appellant were a scheme "contrary to the true intent and meaning of the Companies Act". I know of no means of ascertaining what is the intent and meaning of the Companies Act except by examining its provisions and finding what regulations it has imposed as a condition of trading with limited liability .... we have to interpret the law, not make it." *Salomon v Salomon & Co Ltd*, per Herschell, LJ[1].

Thus the starting point of the court in this seminal case (which has been followed ever since in regard to corporate personality) was to interpret the law as they found it in the Act - if the formalities had been complied with, a separate judicial person came into being:

> "The Company is at law a different person altogether from the subscribers to the memorandum; and, although it may be that after incorporation the business is precisely the same as before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them"[2].

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1 *Salomon v Salomon & Co Limited* [1897] AC 22 at 45-6

2 per Macnaughten, LJ in *Salomon's* case, *op cit* at 51

Thus one of the essential characteristics of a company is its separate identity from that of its members, and this is so no matter how absurd the result may seem at first glance.

The above English case was accepted in our law in *Dadoo v Krugersdorp Municipal Council*[3]. In that case, the AD accepted that the fact that all the members of a company were Asiatic, did not mean that the company could be regarded as Asiatic, and thus the then statute prohibiting Asiatics from owning land in the Transvaal could not be applied to a company:

> "A registered company is a legal *persona* distinct from the members who compose it .... It is not necessary for me to consider the very few cases where in our law the courts have 'pierced the corporate veil'. Suffice to say that in the present case I can conceive of no principle of law whereby such a radical step would be justified."

Thus corporate personality "draws a veil" over what lies behind a company, and generally the courts will not look beyond this. The courts have, however, recognised that in certain cases it may be permissable to disregard the separate existence of the company, and lift the "veil" created by incorporation. This doctrine is exercised

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3 1920 AD 530

sparingly, however, and has seldom been applied in South Africa[4]. So too in Great Britain:

> "However, it must be said at once that (the cases) reveal no consistent principle beyond a refusal by the legislature and the judiciary to apply the logic of the principle laid down in *Salomon's* case where it is too flagrantly opposed to justice, convenience or the interests of Revenue."[5]

Gower goes on to discuss the various situations where the courts have been prepared to lift the veil, and attempts to draw several general conclusions[6], but closes his discussion as follows:

> "Further than this it is not possible to go in attempting to present in a rational form a development which has been essentially haphazard and irrational. Until very recently, the courts and the legal profession have failed to see the interconnection between the various situations in which the problem arises, with the result that relevant decisions taken in one context have not been cited in litigation in another context. That, at least, is better now. But we have not made much progress in producing principles or a consistent

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4 Cf *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1993 (2) SA 784 (C) at 819G

5 Gower *Modern Company Law*, 4th ed, 112

6 Gower *op cit* 112-138

> policy. The most that can be said is that the courts' policy is to lift the veil if they think that justice demands it and they are not constrained by contrary binding authority. The results in individual cases may be commendable, but it smacks of palm-tree justice rather than the application of legal rule."[7]

This note, therefore, will not attempt to develop a unified exposition of the concept in our law, as it is not possible to draw consistent principles from the chaos, save to echo Gower in finding that each case must needs be decided on its own merits. The fact that it may be difficult to make a decision, and that there is a paucity of principle on which to base such a decision will not deter a court from making such a determination, however, and nor will it prevent matters in which the doctrine may have relevance, from coming before our courts. It is, however, clear that the doctrine must be considered in relation to specific facts, and with this in mind, it is proposed to consider the applicability of the doctrine to a common tax-avoidance based structure used in South Africa, whereby the use of a property is split from the ownership thereof, thereby effectively allowing a deduction for income tax purposes of a large part of the capital cost of a property, which capital cost would not normally have been so deductible.

The scheme itself will be covered as briefly as possible, whereafter the recognised areas where the courts have

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7 Gower *op cit* 138

proved willing to lift the veil will be each be discussed - and the facts of the scheme be applied to each such category in turn.

2. THE TAX AVOIDANCE SCHEME

The structure, or scheme, is commonly used to finance the purchase of land and the construction of improvements thereon. Generally, an investment company may, for accounting purposes, depreciate buildings over their lifetime, but no deduction of the capital cost of the building or land is allowed against income for tax purposes. This is in contradistinction to the situation in respect of machinery for example, where the accounting and tax treatment coincides and the plant may be written off against income for tax purposes. There have accordingly been attempts to develop structures within the Income Tax Act[8] where such a write-off for tax purposes may be obtained. Typically, the scheme operates as follows:

The investing company (Investco) would identify a site for development, but instead of purchasing the property itself, it would be purchased by a third party, preferably a company specialising in the development of property, e.g. a project management specialist. This company (Devco) would have no connection with Investco, nor with any shareholder of Devco (i.e. a completely arms-length transaction). It would treat the property as trading stock in its hands, thus deducting the purchase price for income tax purposes.

Simultaneously with executing the contract of purchase, Devco would enter into two further contracts - the first,

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8 Act 58 of 1962, as amended

a contract of lease with Investco whereby Devco undertook to develop the property to Investco's requirements (as stipulated) and to lease the completed building and property to Investco for a considerable period (typically ten or twenty years). The rental payable in terms of the lease would either be payable as one lump sum at the commencement of the lease, or if payable annually it would be settled by the issue of promissory notes (payable on the respective due dates of the annual rental payments) by Investco to Devco at the commencement of the lease. (Devco would then discount these notes with a commercial bank, and thus effectively receive the rental consideration for the entire period of the lease, suitably reduced to take account of the discount factor, immediately). The second contract would be with a another company Propco, whereby Propco purchased the property, subject to the lease (i.e., the bare dominion). As (under either scenario) no rental would be forthcoming for some twenty years, Propco would pay only a small fraction of the total cost of the developed land (i.e. the price would be equal to the present value of the market value of the property at the end of the lease, discounted at the expected long-term cost of capital over the period of the lease).

Devco would then balance its expenditure on the purchase of the property and in developing same to Investco's requirements, with its income from the rent paid up front, together with the receipts from the sale of the bare

dominion to Propco. Any balance would comprise its development profit.

In the classic (or "pure") form of the structure, Propco would be a wholly owned subsidiary of Devco, and therefore Investco would still have laid out the same amount as if it had purchased the land and developed itself (less Devco's development profit), but it would have deducted for income tax purposes that portion of the total costs represented by the rent it paid (depending on the structure, this could exceed 90% of the total cost).

Variations involve using (as Propco) instead of a wholly owned subsidiary, an associated company owned (directly or indirectly) by the holding company of Investco, or a company which is not wholly owned by Investco (i.e. a joint venture). Even where Propco is a wholly owned subsidiary (the common variant), it may have a different board of directors, and may trade in its own right, or it may be especially created or resurrected (from dormancy) to fulfil the rôle of holder of the bare dominion only.

It is not proposed to examine the income tax consequences of the structure in this note, save to record that the benefits could be considerable, and it is assumed (for the purposes of this note) that the rent paid will be allowed as a valid deduction against Investco's income, that Devco will be allowed to treat the property as trading stock (amalgamating rent and sale consideration as income against

a deduction consisting of the purchase price and development costs), and that the structure will not fall foul of the anti-avoidance provisions of §103 of the Income Tax Act[9]. While the above matters are beyond the scope of this note, suffice to say that there are cogent arguments in favour of the assumptions made above, even in respect of the applicability of §103 (which is somewhat rigid in application).[10]

The crisp point which this note seeks to address is this: will a court, accepting that in terms of the Income Tax Act[11] the structure discussed above is unobjectionable, decline to allow Investco its deduction of rent on the grounds that the corporate veil must be lifted to reveal the reality of the underlying situation, i.e. will the court pierce the corporate veil ?

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9 *op cit*

10 see Meyerowitz and Spiro *Permanent Volume on Income Tax* paras 1613 - 1619

11 *op cit*

3. THE APPROACH OF THE COURTS

Cilliers & Benade[12] arrange the instances where the South African courts have disregarded the separate corporate personality of a company, into 7 categories. It is convenient to follow their broad categorisation (to which an eighth will be added); however, it is important not to lose sight of the fact that the courts' approach appears to be essentially *ad hoc* and based largely on the facts of each case.

a. *Daimler Co Ltd v Continental Tyre and Rubber Co*[13]

In this case, the first exception to *Salomon's*[14] case to be recognised by the English courts, the House of Lords held that they were entitled to look beyond the fact that the Daimler Co Ltd was incorporated in Great Britain, to the fact that all its members were domiciled in Germany, which was at the time at war with Britain, in order to categorise the company as an enemy alien.

This category, based on "paramount public interest", deals with nationality, and often (but not always) concerns cases decided during time of war.

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12 Cilliers & Benade, et al *Corporate Law*, 2nd ed, pp 11-12

13 [1916] 2 AC 307

14 *op cit*

As it was said by Flemming, J:[15]

> "Die gevalle wat ek aldus sal noem is: ... As dit gaan om 'n bepaalde kwaliteit van die regspersoon, kan volgens die mate van beheer, eienskappe van die beheerders of aandeelhouers aan die regspersoon oorgedra word .... Ek kan my voorstel dat by die vraag of 'n maatskappy 'n vermoënde koper of 'n aanvaarbare borg is, daar gekyk kan word na die persone wat hul ondersteuning aan die maatskappy gee en hulle finansies. Die assosiasie van sy beheerders met die maatskappy gee hom 'n kleur af."

An example of where the courts declined to lift the veil is *Dadoo's* case[16] where despite the fact that the promoters had used the company to circumvent a statutory provision, Innes CJ held that the *Daimler*[17] case was to be distinguished as in the latter case the enquiry related to attributes which in the nature of things could not attach to a mere legal *persona*, e.g. a company cannot have an enemy character, or be disloyal. On the other hand, a company could hold land, and ownership of such land would vest in the company, and not in its shareholders.

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15 *Botha v Van Niekerk en 'n Ander* 1983 (3) SA 513 (W) at 521

16 *op cit*

17 *op cit*

Clearly, however, this exception has no relevance to the question of whether the veil should be lifted in the context of the postulated scheme.

b. **Underlying Partnership**

In some cases, the courts have recognised the existence of "family companies", or "quasi-partnerships". An example is the case of *Ebrahimi v Westbourne Galleries Ltd & Anos*[18], where the underlying intention was one of partnership, although the partners formed a company to put it into effect. Here, where Ebrahimi was removed as director in accordance with the articles (his erstwhile "partner" & the "partner's" son having voted him out of office), Lord Wilberforce held (allowing the winding up of the company on the "just and equitable ground") that:

> "... a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure."[19]

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18 [1937] AC 360 (HL)

19 *Ebrahimi's* case, *op cit*, at 379 B-C

The learned Lord Justice went on to note that while this did not entitle a person to disregard the obligations he assumed by entering a company, it did allow the court to subject the exercise of legal rights in this context to equitable considerations of a personal character arising between individuals.[20]

Once again, it is clear that this exception to the doctrine cannot be of assistance to the postulated set of facts addressed by this note.

c. Tax liability

Cilliers & Benade write that:

> "As far as the tax liability of a company is concerned the courts will not permit the true state of affairs to be concealed by provisions in the company document (in the objects clause, for example). Regard would be had to the real intention of the board of directors and members."[21]

While at first sight, this principle may seem to be of direct relevance to our set of facts, on closer investigation of the authorities it appears clear that the courts here are concerned with looking

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20 *Ebrahimi's* case *op cit*

21 Cilliers & Benade, *op cit*, p12

within a given company (typically to determine intention) - for example the *Elandsheuwel* case[22], where a company which had held land with a capital intention for many years was found to have changed that intention to a revenue one (and thus became liable for tax on the proceeds), not because of any actions it took in connection with developing, etc, the land (one of the normal tests), but because its shareholding changed, and the new *shareholders* had a "revenue" intention with respect to the *company's* asset, the land.

It is clear, however, that this principle does not extend to the recognition of groups for tax purposes in tax law[23] (as distinct from the question whether courts will lift the veil and look at groups as a whole in connection with other, broader concerns). As Meyerowitz[24] puts it:

> "The fact that companies are associated through shareholding or that one company is the holding company of another has no bearing on the income tax position. Each company is a separate legal entity, separate even from its shareholders, and the deductibility of any expenditure incurred by one company in relation to another must be

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22 Cf *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* 1978 (1) SA 101 (A)

23 Cf *Ochberg v CIR* 1931 AD 215

24 *op cit*, para 723

judged in exactly the same way as if there were no association between them."

d. **Agency**

There is no reason why a company should not act as an agent of its shareholders. The problem arises where the courts seek to use the law of agency to circumvent the problems which would otherwise arise from a too strict application of the principle in *Salomon's* case.[25] In this case, "... the rules of agency are applied ... to regulate a situation for which they were not designed."[26]

Gower[27], recognising that it is difficult (in the light of *Salomon's* case[28]) to persuade the court to draw an inference of agency, divides the cases where the courts have been asked to do so into two areas - the first is where the inference they are asked to draw is that a subsidiary company has acted as agent for its holding company. He argues that the court is less reluctant in these cases (this contention is discussed below under the heading of "Groups"), than where it is asked to treat the company as an agent of

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25 *op cit*

26 Cilliers & Benade *op cit*, p11

27 *op cit*, pp 123-4

28 *op cit*

its individual shareholders. Even in such cases (i.e. Gower's second category of cases):

> "... they have not been willing to do so except where that is necessary to frustrate some grave impropriety, and in such circumstances they have coupled the description of the company as an agent with more pejorative descriptions, such as "sham," "cloak," "device," "stratagem," "puppet," "creature," etc. In truth they themselves seem to have been using a cloak, that of agency principles, to give legal respectability to the use of a sledgehammer."[29]

Accordingly, this second category of cases will be dealt with under the heading of "*alter ego*, cloak or sham", below. As quoted by Cilliers & Benade[30]:

> "It is hardly worthwhile torturing 'agency' to save 'entity'".[31]

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29 Gower, *op cit*, p124

30 *op cit*, p11

31 Cf Latty 1935-36 *Michigan Law Review* 597, 611

e. **Groups**

Will the courts look to the fact that a company is a wholly owned, or controlled, subsidiary within a group, with consolidated accounts, and (possibly) common boards of directors, and look at the group as a whole, rather than at the companies as separate entities? In South Africa the courts have always followed the view as set out by Cilliers & Benade[32]:

> "The mere fact that a holding company is able to control the subsidiary does not make the subsidiary its agent. As a consequence of the separate legal personalities of the holding and subsidiary companies the subsidiary itself and not its holding company will have to institute actions and enforce its rights .... The traditional common law approach is thus that holding and subsidiary companies possess their own legal personalities, rights, assets and liabilities."

The learned authors go on to provide that while modern commercial practice has caused modifications (for example the preparation of group accounts), "the holding company and its subsidiaries do not thereby lose their separate legal personalities".[33]

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32 *op cit*, at 432

33 Cilliers & Benade, *op cit*, p433

This exposition of the law is in accordance with the South African authorities, viz the remarks of Centlivres CJ in *R v Milne and Erleigh (7)*[34]:

> "The persons who wield the controlling power are the only legal *personae* apart from the companies themselves. There is no *persona* which is the group, and there are no interests involved except the interests of the companies and the interests of the controllers. This is not mere legal technicality ... No business man would be deceived into thinking that in a group there is, in effect, a pooling of assets and a right in the controllers to deal with assets belonging to the companies without regard to their respective interests."

This case has been followed in the field of civil law as well, for example being quoted by Preiss, J in the case of *Dithaba Platinum (Pty) Ltd v Erconovaal Ltd and Another*[35]. In that case the applicant had a right of pre-emption over certain mineral rights held by the second respondent (an external company). The second respondent, for administrative convenience, sold all its assets (including the mineral rights) to the first respondent, its wholly-owned subsidiary. For various *bona fide* reasons the rights were valued at an extremely low book value of R118, while it

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34 1951 (1) SA 791 (A) at 823

35 1985 (4) SA 615 (T)

since transpired that they were worth some millions of rands. The applicant, learning of the sale, applied to court to exercise its pre-emptive right and purchase at the derisory amount of R118. The court held as follows[36]:

> "It is clear that the transactions between the respondents, whatever the consequences may turn out to be, were genuine contracts, designed to vest the South African assets of an external company in its wholly-owned local subsidiary. They cannot be stigmatised as constituting a cloak, or a fiction or a sham. The framing of group accounts in the form chosen by the respondents does not in my view advance their cause. They remain, as holding company and wholly-owned subsidiary respectively, separate *personae* with separate identities .... I am therefore not prepared to pierce the veil"

However, (as remarked on above, on page 15), Gower argues[37] that there is a tendency, in the English courts, to be more sympathetic towards the idea of treating a group as a whole. In developing this argument, he relies principally on two cases. The first, *Smith, Stone & Knight Ltd v Birmingham Corporation*[38], (where Atkinson, J allowed a holding

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36 at 625G to 626A

37 Gower, op cit, p124

38 [1939] 4 All Er 116 (KB)

company to claim compensation by reason of the compulsory acquisition of the property of its subsidiary) was severely criticised by Pennington [39] in a passage quoted with approval by Goldstone J in the *Banco de Moçambique* case[40]:

> "For example, in *Smith, Stone and Knight Ltd v Birmingham Corporation* Atkinson J described the subsidiary company as 'the agent or employee, or tool or *simulacrum*' of the holding company, words which are obviously intended to be read in a metaphorical rather than a legal sense. Indeed in that case it was unnecessary for the Court to find that the subsidiary was the holding company's agent in order to reach the decision that the holding company was in occupation of the premises compulsorily purchased."

The second main case (he quotes a number of other cases, decided prior to this one, in support) relied upon by Gower is the case of *D.H.N. Ltd v Tower Hamlets London Borough Council*[41]. Gower states that in that case, Lord Denning, MR was prepared:

> "... to adopt a statement in the previous edition of this book that 'there is evidence of a general tendency to ignore the separate legal entities of various companies within a group,

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39 Pennington, *Company Law*, 4th ed, p54

40 *Banco de Moçambique v Inter-Science Research and Development Services (Pty) Ltd* 1982 (3) SA 330 (T)

41 [1976] 1 W.L.R. 852, C.A.

> and to look instead at the economic entity of the whole group.' And this time in lifting the veil he was able to carry both his colleagues with him. The court held that 'The three companies should, for present purposes, be treated as one, and the parent company, D.H.N., should be treated as that one."[42]

In that case the land vested in one of two wholly owned subsidiaries in a group carrying on a grocery business - if the veil had not been lifted the plaintiffs would have been defeated on a mere technicality since the land could at any time have been transferred from the subsidiary to the parent company.[43]

The English courts have since, however, moved away from this concept. In *Re Southard & Co Ltd*[44], Lord Templeton was at pains to uphold the contrary view, holding that a parent company may spawn many subsidiaries, and if any one should go insolvent, the parent company may properly be without liability for the debts of the insolvent subsidiary.

It is now clear (if it was ever in any doubt) that our courts also, do not follow the view espoused by

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42 Gower, *op cit*, p131-2

43 Gower, *op cit*, p131-2, notes 36 & 37

44 [1979] All ER 556 (HL)

Gower. The AD has recently reaffirmed its view (first enunciated in *R v Milne & Erleigh*[45]) that groups may not be looked at as a whole, in the case of *Wambach v Maizecor Industries (Edms) Bpk*[46], where Van Heerden, JA held as follows[47]:

> "Die respondent se advokaat het ... egter beroep op 'n aantal - meestal Engelse - gewysdes waarin, so is aangevoer, daar 'n ontsluiering van korporatiewe identiteite plaasgevind het ten einde gevolge te gee aan kommersiële realiteite. Nie een van dié gewysdes is in die onderhawige geval van nut nie .... In die verbygaan kan ek meld dat in *Adams and Others v Cape Industries plc and Another*[48]op 532 en 543, die Court of Appeal klaarblyklik nie akkord gegaan het nie met uitlatings in vroeëre beslissings aangaande onsluiering (sic) waarop die respondent se advokaat peil probeer trek het."

There is accordingly no room for the argument that as Investco and Propco form part of the same group, Propco being a wholly-owned subsidiary of Investco, the courts will take a robust view of the scheme, looking at it as a whole and ignoring the existence

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45 *op cit*

46 1993 (2) SA 669 (A)

47 at 675B-E

48 [1991] 1 All ER 929 (Ch and CA)

of the separate companies. Something more than being part of a group is required.

f. **Fraud**

Fraud has always been seen as a circumstance justifying the lifting of the veil, and if fraud is present, the courts have not hesitated to pierce the veil so as to make the individual controllers liable.

A good illustration of the court's approach is the case of *Gilford Motor Co v Horne*[49]. There Horne had entered into a restraint of trade agreement (including *inter alia* an agreement not to solicit its customers) with the company while he was employed by it. He left its employ, and formed a company which undertook the solicitation. As Gower notes[50], the remarkable thing was that:

> "An injunction was granted against both him *and the company* (notwithstanding that it was not a party to the contract). The company was described in the judgement as 'a device, a stratagem,' and a 'mere cloak or sham.'"

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49 [1933] Ch 935 (CA)

50 Gower, *op cit, p126*

This approach has been followed in our law where Le Roux J, in the case of *Lategan v Boyes and Ano*[51], referred with approval to the words of Judge Sanborn in *US v Milwaukee Refrigerator Transit Co*[52], where he held that a company should be seen as an entity:

> "but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association."

The learned judge went on to state that this approach "appears to be in line with that in modern England ... and is based on common sense and a developed sense of equity."[53] He then refers with approval to *Gilford's* case[54], but also cites the case of *Orkin Bros Ltd v Bell*[55] as authority for the proposition. I must, however, respectfully agree with the remarks of Professor Blackman[56] (quoting Professor R.C. Benthin[57]) that the true basis of the decision (where directors were held personally liable to a seller who had sold goods to a company at their insistence at a time when the directors had known

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51 1980 (4) SA 191 (T)

52 (1905) 42 Fed 247 at 255

53 at 201A

54 *op cit*

55 1921 TPD 92

56 Professor Blackman *Notes on Company Law*, unpublished notes prepared for the Commercial Law Department, UCT, 1984

57 Benthin, R.C. *Studies in the field of South African Law, Principally Company Law* Vol 1 at 63 - unpublished LLD thesis

that the company was in insolvent circumstances and totally unable to pay for the purchase, and where it appeared that the sole purpose of the transaction had been to diminish their personal liability under a contract of suretyship) was:

> "... the fact that when directors order goods there is an implied representation by them that they believe that the company will probably be able to pay for the goods, and if they know there is no such likelihood, then they commit such a fraud as falls within the principles laid down in *Derry v Peak* [1889] 14 App. Cas. 337."[58]

Be that as it may, however, Le Roux J went on to find (with respect, correctly, notwithstanding his erroneous reliance on *Orkin's* case[59]), that:

> "I have no doubt that our Courts would brush aside the veil of corporate identity time and time again where fraudulent use is made of the fiction of legal personality. In the present case, however, there is no evidence (of fraud)".

The case concerned a loan to a company wholly owned by the defendants, and in respect of which the defendants had entered into a contract of suretyship. The terms of the loan were varied without reference

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58 Blackman, op cit, "Disregarding the separate existence of the Corporate entity: Piercing the Corporate Veil" p2

59 *op cit*

to the deed of suretyship (although the second defendant signed the amendment to the loan on behalf of the company). The defendants took the point that they had signed on behalf of the company, not as sureties. In reply, the plaintiffs contended that the court should lift the veil. Le Roux, J went on to find that[60]:

> "In fact the evidence shows that all parties concerned, including the attorneys acting for the mortgagor and mortgagee, forgot about the contract of suretyship when the amending agreement was signed. It follows that no question of fraud arises in this case .... The fact that the second defendant, well-knowing what the terms of the amending agreement were, now takes a sharp point on prejudice does not constitute a fraud on the plaintiffs, *although it offends one's sense of equity*." (my italics)

The significance of the italicised words is that the fact even when that which is done seems inequitable and a "sharp point", it does not necessarily constitute fraud.

While the learned judge did remark[61] that "It is interesting to note that the Canadian Courts have refused to disregard the separate identity of

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60 at 201H-202B

61 at 202A

companies except upon proof of fraud ... and there seems no reason to believe that, save where authorised by statute, our Courts would go further at the present juncture" this has been dissented from - see *Botha v van Niekerk en 'n Ander*[62]:

> "Te oordeel aan die formulering van die gedeelte wat op 202A van die uitspraak (i.e. *Lategan's case*[63]) verskyn, is dit waarskynlik verkeerd om te sê dat beslis is dat bedrog altyd 'n voorvereiste is .... 'n akkurate en volledige formulering van die perke van so 'n ignorering (van die skeidslyn tussen 'n maatskappy en sy aandeelhouers) nie moontlik is nie. Dit is te meer in 'n regstelsel wat nie vir groei en ontwikkeling suiwer van wetgewing afhanklik is nie."

Another example of fraud was the case of *Cattle Breeders Farm (Pvt) Ltd v Veldman*[64]. Here the appellant company owned the farm on which its sole shareholder had set up the matrimonial home with his wife. In due course he committed adultery, left the farm, and then proceeded to have the company attempt to eject her from the farm (an action he could not have taken without offering alternative accommodation). The learned Chief Judge ignored the

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62 1983 (3) SA 513 (W) at 519D-F

63 *op cit*

64 1974(1) SA 169 (RA)

fact that the company (and not the husband, who owed the duty) owned the farm, and treated the company as the husbands *alter ego*, holding that it "possessed no greater rights to eject the respondent than (the husband) himself possessed."[65]

Another example, with superficially similar facts to *Gilford's* case[66] is the case of *J Louw and Co (Pty) Ltd v Richter and Others*[67]. In this case Richter owned a road-marking patent, and the parties envisaged him transferring it to his company, J co, which entered into an agreement (during 1979) with the plaintiff whereby, *inter alia*, the plaintiff obtained an exclusive licence over the patent, and both J co & Richter were restrained, directly or indirectly from being interested in any road-marking business whatsoever.

In the event the patent was never transferred to the plaintiff, as it was attached and sold in execution before Richter could transfer it. This put paid to the plaintiff's licence.

During 1985, a company called Lyncor (formed during 1983 by Richter) was successful in tendering for road marking for the Natal Provincial Administration (in

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65 *Cattle Breeders* case, *op cit*, 171F-G

66 *op cit*

67 1987 (2) SA 237 (N)

competition with the plaintiff). Plaintiff sought an interdict against Richter and Lyncor. The learned judge, assuming that the covenant had come into force, noted that whether it had been breached by Richter or not, Lyncor had not been a party to the covenant. As to whether he should pierce the corporate veil, the learned judge reviewed the decisions in *Lategan & Ano*[68], *Banco de Moçambique*[69], *Botha v Van Niekerk*[70] and *Dithuba Platinum*[71], but found no authority. While he recognised that the *Gilford Motor* case[72] did go as far as he was urged to do by the plaintiffs, he held:

> "I am not disposed to follow the decision. That it was proper in the circumstances to enjoin the company seems to have been taken largely for granted .... The case for an injunction against the company was a good deal stronger, what is more, than one for an interdict against Lyncor happens to be. The covenantor had formed the company, the Court found, with the specific intention of using it to evade the restraint, of manipulating it so that it did in his interests and for his benefit things which he was not at liberty to do personally. It had amounted from

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68 *op cit*

69 *op cit*

70 *op cit*

71 *op cit*

72 *op cit*

> the beginning to a 'mere cloak or sham', to naught but a 'device', a 'stratagem', a 'mask', as Lord Hanworth MR characterised it. That Lyncor was likewise conceived in sin does not emerge. Nor is so much suggested. It appears to have been established innocently, honestly and for purposes that were quite above board. It was certainly not conjured up so that Richter, disguised by it, might compete with Louw in tendering for and attending to the job now in hand.This I say because, by the time the tenders were solicited, it had existed and functioned for some eighteen months."[73]

Accordingly, it is clear that the courts will lift the veil if fraud is present. Thus if fraud is part of our proposed scheme, that is will be sufficient to persuade the court to ignore the form and look at the substance, i.e. the group as a whole, disregarding the individual corporate entities.

But is there fraud present in that scenario (even in the "pure" form ?). It will be remembered that *Lategan's*[74] case found that something can offend one's sense of equity, and still not constitute fraud.

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73 Louw's case, at 241G-242A

74 *op cit*

It is submitted that what is being done in terms of the scheme cannot be characterised as fraud on anyone, even Revenue. Propco is not being used by Investco to do something Investco cannot do itself, nor to evade any contractual obligations of Investco. It is quite legitimate to put property into one company and the operations into another, for all sorts of quite proper business reasons. The question must also be posed as to just how is Revenue being defrauded - everything required by Revenue has been disclosed, it is free to ask any further questions it may wish, and the structure cannot be attacked even under the wide anti-avoidance provisions of the Act[75].

More importantly, it is submitted, the Income Tax Act[76] itself implicitly recognises that a taxpayer may so arrange his affairs, using "groups" or "associated" companies, so as to avoid tax otherwise payable - by specifically providing, for example, for a definition of "associated institution"[77].

The language used by the courts is sometimes confusing, because (as we shall see below on page 33), a further category of cases where the courts

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75 Income Tax Act, op cit

76 *op cit*

77 in connection with income tax levied on fringe benfits granted as a concommitant of employment - Para 1 of the Seventh Schedule to the Income Tax Act, *op cit*

will lift the veil is where a company is used as an *alter ego*, a 'sham', 'mask', or 'puppet' of another - in such cases:

> "... the general principal underlying this aspect of the law of lifting the veil is that, when the corporation is the mere *alter ego* or business conduit of a person, it may be disregarded. This rule has been adopted in those cases where the idea of the corporate entity has been used as a subterfuge and to observe it would work an injustice."[78]

Accordingly, this latter category must be differentiated from pure fraud (although the courts also use the terminology of "sham", "mask" etc, in connection with fraud.[79]). It is submitted that fraud has connotations of deliberate hiding away, of the concealment of material facts. Thus, as it has been argued that deliberate dishonesty is not present, then the structure cannot, it is submitted, be characterised as fraudulent (although escaping such a characterisation does not necessarily mean that the courts will refuse to lift the veil). Accordingly it is necessary to discuss under what further circumstances (i.e. where fraud in the pure sense is not present) will the courts be prepared to pierce the veil.

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78 *Cape Pacific* case, *op cit*, at 816J-817A

79 Cf Louw's case, *op cit*, p241I

g. *Alter ego*, cloak or sham

A classic example of where the courts ignored the corporate veil was in the case of *Robinson v Randfontein Estates Gold Mining Co Ltd*[80], where a director attempted to avoid his fiduciary duties to a company of which he was chairman by creating a subsidiary, and selling to that company. This was accordingly a sale to a company of which he was not a director and thus he avoided the disclosure he would have had to have made, had he sold to the company of which he was chairman. The courts simply ignored the subsidiary and held that there had been a breach of Robinson's fiduciary duty to the plaintiff (holding) company.

Perhaps the most extreme case of a refusal to lift the veil under this head, is a New Zealand case heard by the Privy Council, *Lee v Lee's Air Farming Ltd*[81]. Gower[82] relates that:

> "... Lee, for the purpose of carrying on his business of aerial top-dressing, had formed a company of which he beneficially owned all the shares and was sole 'governing director'. He was also appointed chief pilot .... He was killed in

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80 1921 AD 168

81 [1961] A.C. 12 P.C.

82 *op cit*, p123

> a flying accident. The Court of Appeal in New Zealand held that his widow was not entitled to compensation (under the Workmen's Compensation Act) since Lee could not be regarded as a 'worker' .... But the Privy Council ... held that Lee and his company were distinct legal entities which had entered into contractual relationships under which he became, *qua* chief pilot, a servant of the company .... In effect the magic of corporate personality enabled him to be master and servant at the same time and to get all the advantages of both - and limited liability".

Possibly the *locus classicus* under this head is the case of *Wallersteiner v Moir*[83], where various companies through which Dr Wallersteiner (the appellant) had operated were dealt with by Denning MR as if they were "just puppets of Dr Wallersteiner":

> "He (Dr Wallersteiner) controlled their every movement. Each danced to his bidding. He pulled the strings. No-one else got within reach of them. Transformed into legal language, they were his agents to do as he commanded. He was the principal behind them. I am of the opinion that the court should pull aside the corporate veil and treat these concerns as being his creatures

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83 *Wallersteiner v Moir; moir v Wallersteiner and Others* [1974] 3 All ER 217 (CA)

> for whose doings he should be and is responsible."[84]

As far as South African Courts are concerned, in the *Banco de Moçambique* case[85], Goldstone J was asked to lift the veil and infer that the Government of Mozambique (being the sole shareholder in the Banco de Moçambique - the central bank) was the real or beneficial owner of the corporation's assets. In his judgement[86] Goldstone, J referred with approval both to the extract from Gower quoted above (in connection with the discussion on agency, see page 16) as well as quoting the following extract from Pennington[87]:

> "The tenuous evidence from which the Court has implied an agency or trusteeship in some of the foregoing cases naturally leads one to question whether the agency or trusteeship is not merely a convenient legal fiction used by the Court to enable it to give decisions which it thinks just. The description of the subsidiary as the holding company's agent or trustee often appears to be merely an epithet used to indicate the subsidiary's complete subjugation to the holding company, and not a statement of their legal relationship at all."

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84 *Wallersteiner's* case, *op cit*, at 1013

85 *op cit*

86 at 344-5

87 Pennington *Company Law*, 4th ed, p54

The learned judge went on to refer to Lord Macnaughten's judgement in *Salomon's* case [88] (already quoted, during the introductory remarks to this note, above on page 1), and held that:

> "In the present case no single reason has been advanced for creating a new category of case where corporate personality should be ignored .... It is not necessary for me to consider the very few cases where in our law the Courts have 'pierced the corporate veil'. Suffice it to say that in the present case I can conceive of no principle of law whereby such a radical step would be justified".[89]

The most recent example to exercise the minds of our courts is the case of *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd & Anos*[90]. Here Cape Pacific purchased from the first defendant, in 1979, the shares in F company, ownership of which entitled one to the use and occupation of a Clifton flat. The shares were not, however, transferred to plaintiff, but rather to second defendant, and the court held that this was done on the instructions of third defendant (Lubner) in an attempt to evade plaintiff's claim thereto. The court accepted that Lubner controlled first and second defendants,

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88 *op cit*

89 *Banco de Moçambique, op cit* at 345 C-F

90 1993 (2) SA 784 (C)

although a large part of this control was via his control of the trustees of various trusts set up by his father for the benefit of Lubner's children.

Plaintiff had previously obtained judgement against first defendant for delivery of the shares, but this had not taken place as the shares had already been transferred to second defendant and first defendant could not compel second defendant to hand over the shares (second defendant was not named in that action).

The case turned on whether the court should "pierce the corporate veil", because effective control of all the companies had at all times vested in Lubner and because the companies had transferred the shares among themselves on Lubner's instructions in order to defeat plaintiff's claim thereto.

The court held, per Nel J, that while the first defendant was the vehicle through which first defendant controlled the shares in F company, there was no evidence which indicates that the purchase of those shares:

> "... had not been an ordinary transaction and that it had been made solely for the benefit of Lubner or for some sinister purpose. (First defendant) was at all material times a fully owned subsidiary of ... the children's trusts

> .... (and) had assets worth well in excess of R1 000 000 .... and could not, in my view, be described as a puppet, a sham, a mask or the *alter ego* of Lubner. Lubner did control the affairs of (first defendant) and did act as if the flat belonged to him. This might perhaps not have been to the advantage of the children's trusts but the corporate entity ... was certainly not used as a subterfuge or an instrument of fraud or improper conduct. The 'lifting' or 'piercing of (first defendant's) 'corporate veil' would thus not, in my view, assist the plaintiff ...."[91]

As far as second defendant (GLI) was concerned, the learned judge held:

> "In 1979 GLI had already been a long-established company with assets well in excess of R2 000 000. It also cannot be described as a sham, a mask or the *alter ego* of Lubner. Although owned and controlled by Lubner, it carried on business as a separate entity and was not used as a subterfuge or an instrument of fraud or improper conduct. The transfer of the (F company) shares to GLI was not done surreptitiously in that the plaintiff had been informed thereof during June

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91 *Cape Pacific case, op cit* at 821F-H

1980 before the institution of the first action."[92]

What is relevant in respect of our postulated facts, is that while the court found that Lubner used corporate entities to defeat the plaintiff's claim, it refused to look behind those entities, firstly because there was no fraud (plaintiff was aware of the sale and could have joined second defendant in the first action), and secondly (and, with respect, more importantly) because the entities used were (and had been for some time) meaningful trading companies in their own right, with substantial assets of their own. In such circumstances, the fact that they "danced to Lubner's bidding", that he "pulled the strings"[93], was irrelevant.

The *Cape Pacific* case is to be contrasted with the English case of *Jones v Lipman*[94]. Here Gower remarks that:

> "... the defendant attempted to avoid completing the sale of his house to the plaintiff by conveying it to a company formed for the purpose. In ordering both the defendant and his company specifically to perform the contract with the plaintiff, Russel J. described the

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92 *Cape Pacific* case, *op cit*, at 821I-J

93 Cf *Wallersteiner's* case, *op cit*

94 [1962] W.L.R. 832

> company as 'the creature of the ... defendant, a device and a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity."[95]

The lesson is clear - assuming an absence of fraud within the structure, the courts may well decline to lift the veil if Propco is a substantial company, trading in its own right with substantial assets (for example if it holds all the property of the group, and has done so for some time). On the other hand, even in the absence of fraud, where Propco is newly formed to hold the bare dominion in respect of one transaction (or possibly is resurrected from dormancy for such purpose), and does no other trading, it is highly likely, it is submitted, that the courts will hold that it is a "sham", a "puppet" or the *alter ego* of Investco, and thus lift the veil.

h. **The interests of Justice**

There is one final category, not mentioned by Cilliers & Benade[96], or Gower[97], which was first raised in the case of *Botha v Van Niekerk en 'n*

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95 Gower, op cit, pp126-7

96 *op cit*

97 *op cit*

Ander[98] In this case Van Niekerk purchased a house from plaintiff "in his own name and that of a nominee". He failed to provide guarantees as provided for in the contract, and when same were demanded, he eventually responded by declaring that he had nominated a newly formed company (with R1 of capital), to purchase in his place. Plaintiff sought to hold him to the contract, as she saw the company as a "man" of straw.

Justice Flemming "subjected the doctrine (of lifting the veil) to an exacting and wide-ranging analysis"[99]. After analyzing the South African as well as overseas cases, he concludes that it is difficult to lay down hard and fast rules - however:

> "Dit laat nog steeds die taak om 'n grondslag te vind of redes te stel waarom in hierdie geval by die afsonderlikheid van die maatskappy volstaan word. Al skyn geformuleerde reëls onprakties en al kan bindende presedente nie aangehaal word nie, moet 'n benadering tot hierdie geval tog gevind word om "palm-tree justice" te vermy"[100]

His Lordship concluded that while none of the recognised categories would permit him to pierce the

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98 op cit

99 *Cape Pacific* case, *op cit*, at 818C-D

100 *Botha's* case, *op cit*, at 520E

veil, at a later stage, on the proof of further facts the matter may well fall within the rule enunciated in the case of *Orkin Bros Ltd v Bell and Others*[101]. Similarly, on liquidation of the company, it may be able to rely on *Robinson's* case[102], and claim damages from Van Niekerk. He went on to conclude that even if at a later stage, the company proves to be unable to meet its obligations, and there are no grounds on which plaintiff can recover her damages (if any) this would not justify the court to find, on the basis of the present situation, that Van Niekerk should be personally responsible. He concluded by finding that:

> "Ek meen dat daar in hierdie geval ook net tot 'n konklusie van persoonlike aanspreeklikheid sou kon kom as daar ten minste 'n oortuiging was dat applikante 'n ondulbare onreg aangedoen word en wel ten gevolg van iets wat vir die regdenkende duidelik onbehoorlike optrede aan die kant van eerste respondent is."[103]

In the circumstances, as the applicant had entered into the contract without stipulating that any nominee had to be financially secure, and particularly as applicant need not pass transfer

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101 *op cit*

102 *Robinson v Randfontein Estates Gold Mining Co Ltd, op cit*

103 *Botha's* case, *op cit*, at 525F

until she had received her price, the learned judge declined to lift the veil.

This test was referred to by Nel, J in the *Cape Pacific* case[104], apparently with approval, where he said (after finding that neither GLI, nor the first defendant company, were *alter egos* or "puppets" of Lubner (as discussed more completely on page 36 above):

> "The transfer of the (F company) shares to GLI was not done surreptitiously in that the plaintiff had been informed thereof during June 1980 before the institution of the first action. Plaintiff certainly had had full opportunity to join GLI in that action but did not do so. In the circumstances, even if the test formulated by Flemming J, namely 'an unconscionable injustice suffered as a result of what was, to the right-minded person, conduct which was clearly improper' ... is applied, the plaintiff cannot succeed. The transfer of the shares could be described as 'clearly improper' but in my view it did not result in an 'unconscionable injustice'. As stated, the plaintiff had had full opportunity to recover the shares from GLI but did not do so timeously and is thus the author of its own misfortune."[105]

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104 *op cit*, at 622A-B

105 *ibid*, at 821J-822B

It is submitted that this test, even should it be accepted and applied as a further class of exceptions, would not be applicable to our scheme - the essence of this test is that someone must have suffered an "unconscionable injustice", in the context of unfairness, leading to an inequitable result. Fleming, J himself cautioned that:

> "Dit sou ten minste besondere gronde verg; iets wat 'n redelike dwingende noodsaak skep in die beland van geregtigheid om die elementêre van maatskappystigting uit te skryf sodat 'n aandeelhouer of direkteur persoonlik aanspreeklik is op 'n maatskappy se kontrakte."[106]

It is submitted that it is inherent in the words used by the learned judge that what he had in mind was an injustice to one of the parties to a contract, frustrated by the unfair use of an intervening company by another party - to extend the test to include "unfairness" or "injustice" towards Revenue, a government department (even assuming that that is possible), is it is submitted, stretching his words too far. Even if it should be possible to be "unfair" towards Revenue, and the test should be extended to include such, it is submitted that on the postulated facts, that is not what occurred - it is open to the legislature to "set the rules", and this they have

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106 *Botha's* case, *op cit*, at 523H

done, to the extent of enacting several anti-avoidance provisions intended to be broad and wide-ranging in scope (even though in practice they have proved possibly somewhat rigid in application[107]). Having done so, they cannot be heard to cry "unfair" if a taxpayer so orders his affairs so as to fall outside the provisions so enacted. It has long been recognised that:

> "Avoidance of tax must not be confused with evasion of tax. Evasion of tax is a fraud on the Revenue, e.g. rendering false returns, concealing income and the like. The only provisions necessary in regard to evasion of tax ... are those imposing penalties. Tax avoidance on the other hand presupposes some legal arrangement or transaction which, but for some special provision contained in the Act, would not render the taxpayer liable for tax."[108]

While courts have expressed differing perspectives on tax avoidance, Meyerowitz[109] notes that the judgement of Lord Normand in the case of *Vestey's (Lord) Executors v IRC*[110] 'gives the corrective':

> "Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall

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107 See above, page 9

108 Meyerowitz, *op cit*, para 1612.

109 *ibid*

110 [1949] 1 All ER 1108 (HL) at 1120

short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and is disappointing to Inland Revenue. But the Court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved."

4. CONCLUSION

It is, it is submitted, clear from the above exposition that most of the heads under which our courts have justified lifting the corporate veil, have little applicability in relation to the facts postulated in respect of the scheme. That is not a case where the principle enunciated in the *Daimler* case[111] would be applicable, and nor are we dealing with a "domestic" company. While special rules do apply when the courts seek to determine the intention of a company when it is relevant in connection with the levying of income tax, these have never stretched beyond the bounds of each individual company.

It has also been argued that our courts will not recognise the concept of a "group" of companies, but require something more that the mere fact that one company is a wholly-owned subsidiary of another, to strip aside the veil. This "something more" certainly includes fraud, but it is submitted that there is no fraud in the proposed structure - indeed the Income Tax Act[112] implicitly recognises that "groups" ("associated companies") can be used to avoid tax otherwise payable. Justice Flemming has also proposed a further category, based on "an unconscionable injustice", but as is argued above, it is

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111 *op cit*

112 op cit

submitted that this category has no relevance to the postulated facts.

Only one category remains, therefore, which might persuade the court to lift the corporate veil, and treat Propco as part of Investco (and thereby deny Investco its deduction for rent paid). This is if Propco can be characterised as the *alter ego* of Investco, merely a "sham", the "puppet", or "mask" of Investco. Whether it can so be regarded in relation to any actual scheme (based on the principles of our scheme above), will depend on a detailed examination of the facts of that scheme.

Broad guidelines appear to be that if Propco is formed specifically for the transaction, it is more likely to be regarded as a sham, than if it had been formed some time before the transaction had taken place, and more importantly, it had traded and conducted other business during that time. Also, a court is more likely to regard a direct subsidiary as a "puppet" of the holding company (assuming some of the other elements are present), than a company indirectly controlled[113]. Should Propco have a different board of directors to Investco, this would also tend to militate against it being regarded as a sham. Similarly, should Propco be partially owned by a third party, it would be very difficult for a court to regard it as a "puppet" of Investco (unless, of course, the third party is owned or controlled by Investco in turn). The

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113 CF *Cape Pacific* case, *op cit*

level of assets and business conducted by Propco would also be of great relevance to the court - if it has substantial assets, apart from those received in the course of the scheme, the court will be far less likely to regard it as a mere "puppet" of its holding company.

The essence appears to be that Propco must be a "real" entity, and not something merely put into place to facilitate the scheme - just as Devco (for income tax considerations) must preferably be a functioning property developer with a respectable track record, so must Propco preferably be, for example, a functioning property holding company for the group, with a mix of performing (rental producing) and non-performing assets. In such event, Investco may well succeed in preventing any lifting of the veil, and so obtain considerable advantages in the course of its business.

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