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THE PIERCING OF THE CORPORATE VEIL IN LATIN AMERICAN  
JURISPRUDENCE, WITH SPECIFIC EMPHASIS ON PANAMA.

To what extent can the Hispano-American principle of *sana critica* supplement an  
approach to pierce the corporate veil in Panama?

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*To my Parents*

## Introduction

The modern corporation (or company and any other form of business association) has the attributes of legal personality and shareholders' limited liability. The attribute of legal personality allows the corporation to have rights, own assets, contract and be liable for its acts.<sup>1</sup> The attribute of limited liability, on the other hand, limits shareholders' liability for the corporation's acts merely to the extent of their contribution to the corporation's assets.<sup>2</sup> These attributes of the modern joint stock corporation have been key for the development of modern society. However, corporate personality and limited liability have also made the joint stock corporation a suitable device for the practice of fraudulent acts. Therefore, the piercing<sup>3</sup> of the corporate veil is a means to prevent and punish the use of the corporate personality for fraudulent purposes.<sup>4</sup>

The piercing of the corporate veil sets aside the corporation's legal personality in order to make shareholders liable for the corporation's acts.<sup>5</sup> Although this may appear to be an easy task, it is far from so. In fact, there is a dilemma about whether or not to ignore the corporate personality. This dilemma arises from the fact that the purpose of the corporate entity is to protect investors from a risk that involves a commercial adventure via transferring the risk of an enterprise to creditors and third parties. Indeed, the corporate entity can be used in ways that may produce an unfair result and consequently enable fraud. Undisputedly, unfairness is present when a corporate entity defaults but if the corporate personality were easily disregarded every time unfairness and fraud are argued, there would be no benefit from its use. Moreover, investors would hesitate before participating in risky enterprises were their assets to be exposed and thus all socio-economic benefits would be lost.<sup>6</sup>

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<sup>1</sup> See, Ivamy, H. **Dictionary of Company Law**. London: Butterworths; 1983. At page 43

<sup>2</sup> *Ibid*

<sup>3</sup> English lawyers often use this term interchangeable with lifting.

<sup>4</sup> There may be other grounds for piercing the corporate veil. However, the majority involve fraud. Therefore, in this thesis I focus mainly on piercing the corporate veil in the context of fraud.

<sup>5</sup> *Ibid*

<sup>6</sup> The author David Millon states that limited liability provided by the corporate personality produces unfairness in some circumstances. However, limited liability enables aggregation of large amounts of capital from numerous small investors. If liability were not limited, even a small investment could

The piercing of the corporate veil first took place in Anglo-American jurisdictions.<sup>7</sup> Consequently, the piercing of the corporate veil has been studied mainly in Anglo-American jurisdictions. Other regions, such as Latin America, could be considered as having been neglected and thus little regarding corporate personality issues in this region has been written. There are strong reasons for this region not to be the subject of attention in this context; for example, slow economic and legal development due to political and economical instability. Definitely, if a country is not prosperous, the use of the corporate personality is not common and corporate personality issues are therefore not frequent.

In the last two decades, however, some countries across Latin America have gained political stability and experienced steady economic growth.<sup>8</sup> Consequently, the corporate personality has played an important role in the development of Latin America.<sup>9</sup> Indeed, as a vehicle for investment, it has facilitated the development of infrastructure.<sup>10</sup> In addition, small entrepreneurs have found the advantages of the corporate personality and limited liability particularly convenient.<sup>11</sup> Nonetheless, the use of the corporate personality has also given rise to common corporate personality issues.<sup>12</sup> Consequently, measures to deal with corporate personality issues have been taken.

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render a shareholder liable for a substantial corporate obligation. Thus, many people would be reluctant to risk their personal wealth in exchange for the prospect of only a modest return. At best, limited liability encourages investment that otherwise would not occur. Millon, D. **Piercing the Corporate Veil, Financial Responsibility and the Limits of Limited Liability**. SSRN eLibrary. 2006. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=451520](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=451520) [last visit may 30, 2013] at page 1312

<sup>7</sup> The modern joint stock corporation has its origins in England, where the Medieval corporation was first used as a device for commerce. However, the joint stock corporation has been used to greater extent in the U.S.A.. Consequently, the modern joint stock corporation can be considered as having been developed in Anglo-American countries. Moreover, as the piooners on the use of the modern joint stock corporation, Anglo-American jurisdictions were the first to experience the effects of corporate personality issues, a fact that makes Anglo-American jurisdictions the first to experience the dilemma that surrounds the piercing of the corporate veil. **See, Chapter One**, at page 24

<sup>8</sup> Latin American economic expansion has been a product of institutional and political changes brought about by national and international factors such as the globalisation process and democratisation of Latin American countries. Bertola, L. & Ocampo, J. **The Economic Development of Latin America Since Independence**. United Kingdom: Oxford University; 2012. At page 258

<sup>9</sup> Villegas, C. **Tratado de las Sociedades**. Chile: Editorial Juridica; 1999. At pages 29-35

<sup>10</sup> *ibid*

<sup>11</sup> *ibid*

<sup>12</sup> This statement is supported on the premise that only in prosperous countries the corporate personality is of common use. This premise is discussed and proved throughtout this thesis.

The piercing the corporate veil in Latin American jurisdictions, with emphasis on Panama, is the subject of study in this thesis. The desire to engage in this study derives from the lack of research on this subject. The piercing of the corporate veil is a relatively recent subject in Latin America and there has been little research about the methods used by countries in the region. Moreover, I have emphasised Panama due to the relevant role of the corporate entity in this country and the lack of an approach to deal with corporate personality issues. Panama is a Latin American country that is currently experiencing a steady economic growth and with it the use of the corporate entity has become more common. Panama presents a case study due to the environment in which the corporate personality has been developed. Indeed, the corporate personality and all related aspects are addressed in accordance to each jurisdiction's legal and economic framework. In the case of Panama, this jurisdiction has developed as a financial offshore service centre. The Panamanian corporate entity is known for being a convenient device to conduct business strategies such as lower transaction costs, reduced taxation charges and the protection of assets.<sup>13</sup> Besides the benefits available for foreign and national entrepreneurs, the incorporation of Panamanian companies is a profitable business for the government, law firms and banks. Consequently, discussing the piercing of the corporate veil has been 'taboo' among many different sectors of Panamanian economy/society. There is a common perception that should an exception to the corporate personality exist, it would dramatically undermine the Panamanian corporate entity.<sup>14</sup> However, the Panamanian Supreme Court of Justice<sup>15</sup> has not been blinded by this belief and has ignored the corporate personality when it has been evidently misused. In the little Panamanian case law existing with regard this context, the Panamanian Supreme Court has emphasised the fact that it will not allow the use of the Panamanian corporate

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<sup>13</sup> See, <http://www.offshorepanamaniancorporations.com/#panamanian-offshore-corporations> [last visit July 25, 2013]

<sup>14</sup> See, <http://www.laestrella.com.pa/online/impreso/2011/10/18/sociedades-anonimas-pero-sin-el-velo-del-anonimato.asp> [last visit July 25, 2013]

<sup>15</sup> The Supreme Court of Justice is the highest judicial authority in Panama. The Supreme Court of Justice has jurisdiction over the Republic of Panama's territory and is located in Panama City. The Panamanian Supreme Court of Justice is composed of four chambers and nine magistrates. The First Chamber has jurisdiction over civil matters, the Second Chamber has jurisdiction over penal matters, the Third Chamber has jurisdiction over administrative matters and the Fourth Chamber deals with "negocios generales" (special matters). The Panamanian Supreme Court of Justice also has jurisdiction over constitutional matters, the "Pleno de la Corte", which is the gathering of the nine magistrates, is the means through which the Supreme Court of Justice defends and enforces the constitution. See, <http://www.organojudicial.gob.pa/tribunales/corte-suprema-de-justicia/> [last visit August 20, 2013]

personality to conceal fraudulent acts.<sup>16</sup> Certainly, Panama is a jurisdiction that seems to be pro-corporate personality but the reflections of the Panamanian Supreme Court feed the premise that possible exceptions to the corporate personality are likely to be introduced in this jurisdiction.

Panama follows the civil law tradition, a legal tradition that adheres to positive law.<sup>17</sup> Consequently, an exception to the corporate personality is likely to be developed in positive law. This belief is supported by the fact that those Latin American countries that have introduced the piercing of the corporate veil (Colombia, Argentina, Chile and Brazil) have done it through a statutory rule.<sup>18</sup>

This thesis follows the belief that the problem does not lie in the drafting of the statutory exception, but in the ability of civil law judges to interpret and reflect over the statutory rule. Civil law tradition is known for its tendency to adhere to statutory rules and a judge's limited capacity to correctly interpret and go beyond the boundaries of positive law; an aspect of the civil law tradition that is incompatible with piercing the corporate veil. Whether the corporate entity has been improperly used is something that cannot be described nor summarised in a statutory rule. The use of the corporate personality produces circumstances that cannot be predicted nor foreseen. Thus, in order to determine whether there has been fraud or an abuse of rights, the judge needs judicial creativity in order to assess the facts specific to the case and the applicable law.

One should not omit the fact that civil law tradition is strict for the sake of legal certainty. To confer the civil law judge judicial discretion is against the principles of this legal tradition. Nonetheless, throughout the development of this legal tradition, principles to soften such rigid civil law have been developed. An example of this is

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<sup>16</sup> See, **Chapter Four**. At page 174-177

<sup>17</sup> The adherence to positive law is one of the characteristics of the civil law tradition. In the civil law tradition it is considered that legal certainty is achieved through positive law. In the interest of legal certainty, Judges are prohibited from making the law; legislation should be clear, complete and coherent in the interest of certainty. The intent on making the law free of personal interpretation by a judge prevents the concurrence of personal biases that can distort the administration of justice. Perdomo, R. & Marryman, J. **The Civil Law Tradition: An Introduction to the Legal Systems of Europe and Latin America** 3rd Edition. California: Stanford University Press; 2007. At page 48

<sup>18</sup> Latin America is a region that follows the civil law tradition due to colonial influence. This region was mainly colonised by Spain. Consequently, the legal framework of Latin American countries has been heavily influenced by Spanish civil law. See, **Chapter Five**. At page 188-192

the principle of *sana critica*, which is a procedural principle founded on a set of rules which aims to guide reasoning.<sup>19</sup> However, to what extent can the Hispano-American principle of *sana critica* supplement an approach to pierce the corporate veil in a civil law jurisdiction such as Panama?

In this thesis, the principle of *sana critica* is proposed as a means to supplement a potential approach to deal with corporate veil issues in Panama.<sup>20</sup> The proposal to use *sana critica* derives from the belief that *sana critica* was developed in a drive to make civil law tradition less strict, not by giving excessive judicial discretion to the judge but rather by encouraging the use of legal reasoning over any mechanical application of the law. The proposal of using *sana critica* to support an approach to deal with corporate personality issues is a personal initiative. I consider *sana critica* is unappealing to other academics since it is a procedural principle. However, I regard *sana critica* as something more than a procedural principle. *Sana critica* is composed of values that can most definitely supplement an approach to deal with corporate personality issues in a Latin American civil law country such as Panama.

## **Justification**

There is a lack of research regarding the piercing the corporate veil in Latin America. The little research on this subject has been mainly descriptive. My research is important because it sheds light on the “Latin American piercing of the corporate veil”. My research does not merely describe the “Latin American piercing of the corporate veil”, but also studies its rationale and foundation. In my research I have noticed that the rationale for piercing the corporate veil and the influence of legal tradition have not been properly addressed. These are two aspects I personally consider to be key in the understanding of piercing the corporate veil. Firstly, a remedy that can distort the legal framework for companies cannot be applied without justification. Such a remedy must be introduced in accordance to a legal need. Secondly, the influence of legal tradition cannot be omitted. Legal tradition establishes the principles on which a legal system is structured. Consequently, when

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<sup>19</sup> See, **Chapter Five**. At page 187

<sup>20</sup> See, **Chapter Five**. At page 205-209

introduced the piercing of the corporate veil must be compatible with the principles established by legal tradition.<sup>21</sup>

I consider the omission of these two aspects as the cause for the lack of understanding the piercing the corporate veil in Latin America. Moreover, the omission of the role of legal tradition has created an erroneous belief that Latin American countries have borrowed or copied the Anglo American doctrine of piercing the corporate veil.

Throughout my research I stress the rationale behind the “Latin American piercing of the corporate veil” and the influence that legal tradition has. My objective is to demonstrate the originality and creativity of Latin American jurisdictions when dealing with corporate personality issues. Moreover, I wish to stress the differences that exist between “Latin American piercing of the corporate veil” and the Anglo-American doctrine of piercing the corporate veil.

My research question derives from an interest in proving the originality of Latin American means of dealing with corporate personality issues. Throughout my research regarding the Anglo-American doctrine of piercing the corporate veil, the role of judicial creativity and the use of equity have interested me. These two aspects have led me to consider whether civil law tradition is a concept equivalent to common law equity or one that could at the very least provide the judge with a degree of judicial creativity. The principle of *sana critica* commanded my attention and inspired my research question.

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<sup>21</sup> For example: the civil law tradition is strict for the sake of legal certainty. To confer the civil law judge judicial discretion is consider undermines legal certainty. The adherence to positive law is a principle on which the civil law tradition has been structured.

## Methodology

I consider the piercing of the corporate veil to be a remedy that has resulted from the imperfection of economic development and has been implemented in accordance to the legal framework and needs of each jurisdiction. I have developed this personal concept about the piercing of the corporate veil from the following premises:

- Only in prosperous Latin American countries is the corporate personality of common use. The frequent use of the corporate personality makes corporate personality issues common. Thus, it is more likely that in prosperous countries does an approach to deal with corporate veil issues exist.
- Legal tradition and politic-economic factors are determinant when it comes to piercing the corporate veil, thus rendering the piercing of the corporate veil a remedy developed in accordance to the individual needs of each jurisdiction.

Throughout this thesis I demonstrate these premises and not only do I validate my argument about piercing the corporate veil, but also the rationale of my research question. Indeed, the proposal to use *sana critica* derives from my belief that each jurisdiction develops its approach to corporate veil issues by using tools already provided by its legal system. *Sana critica* is a tool that exists in the Panamanian legal framework and this thesis argues its suitability to be applied in this context.

In order to prove the premises that are the basis of my thesis, I have engaged in a comparative law study.<sup>22</sup> Argentina, Colombia, Chile, Brazil and Panama are the Latin American jurisdictions studied in this thesis. Spain is the Continental Jurisdiction included in this thesis. England and the U.S. are the common law case studies in this context.

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<sup>22</sup> For the purpose of this research I have used the ‘functional method’. Based on this method I have used the Anglo-American approach to deal with the corporate veil as template. The objective is to determine whether Latin American jurisdictions use the same method as Anglo-American jurisdictions, or whether Latin American countries have a different approach to achieve a similar result. Functional comparative law focuses on the means used by different jurisdictions to deal with an specific issue.

The piercing of the corporate veil is a recent subject in Latin America and consequently there is a lack of material and research. Consequently, the inclusion of four Latin American jurisdictions in addition to Panama was decided in order to have a more consistent comparative study. Moreover, Latin America, Argentina, Colombia, Chile and Brazil are the jurisdictions that have dealt with corporate veil issues to a greater extent. Consequently, the study and comparison of these jurisdictions have provided an idea about a uniform trend followed by Latin American countries, which is the use of statutory rules based on traditional legal concepts to deal with corporate veil issues. However, although these jurisdictions follow a similar method, the concepts that have been used and the extent to which exceptions to the corporate personality are used varies in each of these jurisdictions.<sup>23</sup> Panama is, I personally consider, likely to follow this trend and in this thesis *sana critica* is regarded as suitable in this context.

Latin America follows the civil law tradition due to a concurrence of different factors. A relevant factor was the influence of Spain during the colonial period. Latin American countries (with the exception of Brazil) were originally Spanish colonies and have their legal roots in Spanish legislation. Moreover, the concept of *sana critica* has been developed by Spanish Courts and adopted by Latin American countries. For comparative purposes, the study of Spain contributes to this thesis as in Spain the piercing of the corporate veil has been developed differently compared to other Latin American countries. Certainly, this fact triggers the following question: why have Latin American countries not used the Spanish approach as a model? The answer to this question is based on the uniqueness of each jurisdiction when it comes to dealing with corporate personality issues. Each jurisdiction may have a different legal need based on economic and political factors. This consequently influences the method used to deal with corporate personality issues.

I have dedicated a section of this thesis to comment upon general aspects of the corporate personality in Latin America. The attribute of corporate personality and limited liability is not exclusive to the joint stock corporation as other types of

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<sup>23</sup> See, **Chapter Three**. At page 111-116

business association with these attributes have been developed throughout the years. The *sociedad de responsabilidad limitada*, *sociedad por acciones simplificadas* and *sociedad unipersonal* are examples of business entities used in the jurisdictions subject of study.<sup>24</sup> I have dedicated a section to define these business entities because in some of the jurisdictions studied in this thesis, they are commonly used. Therefore, the exception to the corporate personality has been aimed at these business entities rather than the joint stock corporation.

The Latin American countries addressed in this thesis have used traditional legal concepts and principles to draft the statutory exceptions to the corporate personality. Hence, before engaging in comparing the different approaches, I have established the definition and purpose of these concepts. It is also important to add that the jurisdictions subject of this research are Spanish-speaking countries, with the exception of Brazil. However, language does not represent a strong barrier since legal concepts and doctrines have a similar orthographical basis.

Regarding case law, researching cases about corporate personality in Latin America was a challenging task. Data bases such as <http://www.organojudicial.gob.pa/> (a Panamanian data base), <http://www.cortesuprema.gov.co/> (a Colombian data base) and <http://www.poderjudicial.cl/> (a Chilean data base) among others provide few cases that directly deal with *rasgado del velo corporativo* (the piercing of the corporate veil) or *levantamiento del velo corporativo* (lifting the corporate veil). This can be attributed to the fact that piercing of the corporate veil is a relatively new concept in Latin America. Thus, some of the relevant corporate personality cases do not overtly address the concept of piercing the corporate veil. In order to find some of the cited cases in Chapters Two and Three, I used alternative terms such as *persona societaria* (a term equivalent to the concept of corporate entity) and *inoponibilidad de la persona juridica*. Additionally, I also sought cases cited by Latin American authorities in decisions where piercing of the corporate veil was unequivocally addressed.

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<sup>24</sup> See, **Chapter Three**. At page 111

This thesis deals with piercing the corporate veil in Latin American jurisdictions. Nonetheless, the parent jurisdictions of the modern corporate entity and the first to experience corporate personality issues cannot be ignored. England and the U.S. have been included as part of this study. These jurisdictions follow the common law tradition. The common law tradition is a legal tradition that has allowed judges the ability to critically assess the concept of corporate personality. However, English and American courts have different opinions regarding piercing the corporate veil. On the one hand, the English courts are reluctant to ignore the corporate personality and seek alternative means, while on the other hand, the U.S. courts are more open to reflect and consider ignoring the legal entity.<sup>25</sup> My objective is not to repeat previous studies about piercing the corporate veil in Anglo-American jurisdictions; rather, it is to compare the Anglo-American and Latin American methods employed to deal with corporate personality issues and in turn support my statement regarding the influence of legal tradition over this subject.

Currently, there is an erroneous misconception that piercing of the corporate veil is an American practice adopted by Latin American jurisdictions.<sup>26</sup> One of the key purposes of my comparative study is to disprove this statement by presenting the differences between the Latin American and Anglo-American methods.

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<sup>25</sup> See, **Chapter Two**. At page 106

<sup>26</sup> The author Jose M. Bello, in his paper regarding the piercing of the corporate veil in Latin America, considers the piercing of the corporate veil as a concept borrowed by Latin American jurisdictions. He states that “the doctrine of piercing the corporate veil has been trying to make its way through Latin America.” This belief is not shared in this thesis due to the fact that the corporate personality is a universal concept; a point addressed later in more extent.

See, Bello, j. **An Overview of the Doctrine of the Piercing of the Corporate Veil as Applied By Latin American Countries: A U.S. Legal Creation Exported to Civil Law Jurisdictions [Argentina/Mexico/United States/Venezuela]**. *ILSA Journal of International & Comparative Law*. Volume 14, Issue 3. At page 628

## **Thesis Structure**

This thesis is composed of five chapters. The first chapter addresses general aspects regarding the piercing of the corporate veil. The rationale for this chapter is to give a brief overview of piercing the corporate veil and address basic aspects that will be covered in this thesis; for example, piercing the corporate veil in corporate groups and piercing the corporate veil in the context of privately owned companies. Additionally, reasons for not covering points such as piercing the corporate veil in the context of public companies will be mentioned.

The second chapter is dedicated to studying the piercing of the corporate veil in England and the U.S.. These jurisdictions are the parents of the modern corporate personality and general aspects about piercing the corporate veil derive from these countries. Thus, Chapter Two can be regarded as a continuation of Chapter One. My purpose is to present the Anglo-American piercing of the corporate veil for it to be contrasted in Chapter Three. Chapter Two starts by addressing the piercing of the corporate veil in England and the reasons for the current position of English courts over this matter. The second part of this chapter is dedicated to the U.S. and its approaches developed in order to deal with corporate personality in that jurisdiction. This chapter concludes by stating the reasons why these jurisdictions have different positions regarding this subject.

The third chapter will cover the piercing of the corporate veil in Spain and Latin America. This chapter starts by addressing general aspects of the corporate personality in Spain and Latin America as well as civil law concepts and principles used by these jurisdictions when dealing with corporate personality issues. The second section of this chapter is dedicated to Spain and corporate personality issues in that jurisdiction. Following, is the third section which starts by making a brief comment about the reasons for choosing the jurisdictions subject of study before continuing by addressing Argentina, Chile, Colombia and Brazil individually. This chapter ends by making a comparison between the methods used by Spain and the discussed Latin American jurisdictions.

The fourth chapter is dedicated to the main case study, Panama. In this chapter, basic aspects of the Panamanian corporate entity in addition to the way in which Panamanian authorities have dealt with corporate veil issues to date are addressed.

Finally, the principle of *sana critica* will be explained in the fifth chapter. The origins and rationale for the existence of *sana critica* and the reason to consider it suitable for supplementing an approach to deal with corporate veil issues. In addition, each of the rules on which *sana critica* is founded will be explained as well as the influence these rules have had over judges' thinking and judgments. This chapter ends with a suggestion for the development of an approach to deal with corporate veil issues in Panama.

## CHAPTER I: General Aspects of the Piercing of the Corporate Veil

The piercing of the corporate veil can be defined as the attribution of liability to shareholders for the corporation's acts in circumstances where the corporation has been used for fraudulent purposes.<sup>27</sup> Indeed, this sounds simple but it is not. The rationale for the use of this remedy is primarily the prevention and punishment of fraud. However, in this context what can be considered as fraud? The corporate personality can be used in ways that may produce an unfair situation and in turn give basis to argue the existence of fraud. However, to what extent can acts under the cover of the corporate personality be considered as fraudulent?

The objective of this chapter is to present the origins of piercing the corporate veil, the reason to use this remedy and the advantages and disadvantages regarding this practice of the piercing the corporate veil. By establishing the basics of the concept of piercing the corporate veil, one is allowed to introduce the subject of this thesis, the principle of *sana critica*. In this chapter, the reader will be introduced to this civil procedural principle and the motive for considering this principle as suitable for the development of an approach to deal with corporate veil issues in a civil law jurisdiction such as Panama.

In addition to the concept of piercing the corporate veil and the principle of *sana critica*, this chapter also seeks to cover key aspects of the corporate personality that have generated debate in this context such as corporate groups and privately owned and publicly owned companies. As an introductory chapter, it intends to present basic concepts and personal observations that will be addressed more extensively later in this thesis.

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<sup>27</sup> There are other grounds on which is justify piercing the corporate veil. However, fraud is the most common. Scheneeman, J. **The Law of Corporations and other Business Organizations**. 6<sup>th</sup> edition. The U.S.A: Delman Cengage Learning; 2012. At Section 7.6, page 271

## 1.1 The Concept of Legal Personality, Limited Liability and the Corporate Veil

The corporation has the attributes of legal personality and shareholders' limited liability. Based on these attributes, the corporation is an independent legal person with the capacity to act in the commercial and legal world and be held liable for its own acts. This means that shareholders are free from any liability derived from acts made by the corporation under its name. Moreover, the corporation is also free from any liability derived from acts of a shareholder. The fact the corporation is an independent entity with capacity to contract and own assets produces advantages such as the reduction of transaction costs.<sup>28</sup> Furthermore, investors' assets are safer because they are economically liable only for the extent of their contribution to the corporation's assets.<sup>29</sup>

Legal personality and limited liability can be described as the foundation of modern Anglo-American corporation law and furthermore, the corporation law of the civil law tradition countries.<sup>30</sup> However, it is important to understand that legal personality and limited liability are different concepts. In the early days of the modern joint stock corporation, this type of business association received the attribute of legal personality but it did not provide shareholders with limited liability (explained in greater detail in Chapter 2). The fact that the fiction of legal personality allowed a group of investors to be identified under a common name did not mean that the investors would have limited liability. Therefore, the concept of limited liability was introduced.<sup>31</sup> The purpose of creating a general rule of limited liability was to increase the advantages of trading under corporate form by limiting the shareholders' liability only to the extent of their contribution in the corporation's assets.

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<sup>28</sup> For example; the investors' ownership interest is represented in shares, which can be transferred without the need to transfer the business itself. Consequently, capital can be raised from investors over time, while avoiding costs of transferring the assets when new shareholders join the company. See, Mevorach, I. **Insolvency within Multinational Enterprise Groups**. New York: Oxford University Press Inc; 2009. At page 41

<sup>29</sup> The limitation of liability has significant economic advantages such as a decrease in the need of shareholders to monitor the managers of the companies in which they invest because the financial consequences of company failure are limited. Consequently, investors can diversify their investment to different enterprises. See. Goddard, D. **Corporate Personality-Limited Recourse and its Limits**. Gratham R. and Rickett C. **Corporate Personality in the 20th Century**. Oxford: Oxford University Press;1998. At page 17

<sup>30</sup> See, Rosas, J. **La Persona Juridica Societaria**. Mexico: Oxford University Press; 2001. At page 5

<sup>31</sup> See, **Chapter Two**. At page 20

The concepts of corporate personality and limited liability are summed up in the metaphor of the “corporate veil”. This metaphor was created in American courts and consists of there being an imaginary veil that separates the existence of the company from that of its shareholders.<sup>32</sup> The existence of the corporate veil is strongly supported in law and jurisprudence in common and civil law jurisdictions. The acceptance of the corporate veil has been based on the socio-economic benefits it has produced. It allows easy gathering of capital due to the safe environment it creates for investors, which in turn has allowed technological innovation and the development of a necessary infrastructure for countries to develop. However, the corporate veil has not only produced economic advantages. It has also been used to practice fraudulent acts. Trading under the corporate form creates a situation whereby shareholders can actively participate in fraudulent acts. As a consequence, “the piercing of the corporate veil” has been introduced in order to counter the misuse of the corporate veil.

## **1.2 What is “Piercing the corporate veil”?**

In this thesis piercing the corporate veil is defined as the means to ignore the corporation’s legal personality and hold shareholders liable for the acts and obligations of the corporation.

Originally, company law in common law and civil law jurisdictions did not include an exception to the corporate personality and limited liability.<sup>33</sup> The early issues that required ignoring the existence of the corporate veil were addressed through

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<sup>32</sup> See, Barsallo, P. *La Doctrina del Velo Corporativo*. *Revista LEX*.( Issue 160). 1996. At page 162

<sup>33</sup> It is important to add that unlike legal personality, limited liability usually is not mandatory for all corporations. Limited liability is a concept separate to corporate personality. Consequently, it is possible to deal with liability issues without affecting the integrity of the corporate personality. A common way is to contract around limited liability; for example, a creditor that contracts with a company is actually contracting with the company and not with the shareholders. Therefore, the creditor and the company are the parties of the contracts, not the shareholders, who would be regarded as third parties in this situation. The creditor, however, can seek personal guarantees from shareholders in order to secure his credit. Consequently, if the company defaults, the creditor can recover his credit from the shareholders without affecting the corporate personality. This fact describes a means to deal *ex-ante* with liability issues. However, in corporate veil issues, usually no preventative measures have been taken by the plaintiff, thus the lack of an statutory exception to the corporate personality and shareholders limited liability creates a difficult situation.

traditional legal concepts and legal devices that could be applied depending on the circumstances of the case (this point will be addressed more extensively throughout this thesis).<sup>34</sup> Gradually, approaches<sup>35</sup> to deal with corporate veil issues have been introduced; nonetheless I have to point out that the legal tradition followed by a country is a factor that has influenced the way an approach to pierce the corporate veil has been developed in each jurisdiction. This premise is developed from the fact that judges in common and civil law jurisdictions have a different degree of freedom in using critical thinking. On the one hand, the common law judge has the ability to act beyond the boundaries of statutory law, which has been useful in dealing with corporate veil issues. Consequently, common law jurisdictions have relied on doctrinal approaches to deal with corporate veil issues. On the other hand, in civil law jurisdictions the piercing of the corporate veil has been addressed in an alternative way due to the limitations of the civil law judge to act beyond a statute. Civil law jurisdictions have relied mainly on statutory exceptions to the corporate personality.

The piercing of the corporate veil has a different basis depending on whether it is applied in a common law or civil law jurisdiction. However, there is a factor that common and civil law jurisdictions share, the rationale to apply this remedy: “the prevention and punishment of fraud”.<sup>36</sup>

The prevention and punishment of fraud have been the justification for the creation of an exception to the corporate veil. However, in the context of the corporate veil, the definition of fraudulent behavior varies across common and civil law jurisdictions. There is not a concrete definition of what can be seen as fraudulent behavior. Consequently, it can be considered that each jurisdiction uniquely engages itself in determining what can be viewed as fraud in this context.

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<sup>34</sup> See, **Chapters Two and Three**.

<sup>35</sup> Examples of approaches to deal with corporate personality issues are the American doctrine of instrumentality and the Argentinean *inoponibilidad de la persona juridical*. Each is explained in Chapters Two and Three, in addition to the approaches used by other jurisdictions studied in this thesis.

<sup>36</sup> I regard the prevention and punishment of fraud as the rationale for piercing the corporate veil. Certainly, each jurisdiction has a different legal system and needs. However, the concept of corporate personality and all it entails is universal. In common and civil law jurisdictions, the corporate entity is recognised but its existence has been questioned mainly on grounds of fraud. Other issues that do not necessarily involve the concurrence of fraud have also triggered the debate over the corporate personality. Nonetheless, fraud has been the main reason to consider this action. This is an argument that I will discuss throughout this thesis and support with my comparative study.

I regard piercing the corporate veil as a remedy that each jurisdiction has developed individually. Piercing the corporate veil has been shaped in accordance to the social, political and economic factors of a particular jurisdiction. The differences regarding the application of this remedy can be appreciated in Chapters Two, Three and Four, where the piercing of the corporate veil in England, the U.S., Spain, Argentina, Colombia, Brazil, Chile and Panama is presented.

It should be added that in both common and civil law jurisdictions, the piercing of the corporate veil has been a controversial subject. The corporate personality has gradually gained relevance due to the socio-economic benefits it produces. Consequently, in common law and civil law jurisdictions, a tendency to preserve the corporate veil has been developed. This tendency has been founded on the fact that if the corporate veil could be easily pierced, there would not be any point in incorporating a company, as every claim against the company would most probably jeopardise the investors' assets.<sup>37</sup> Consequently, investors would be reluctant to participate in risky enterprises and the socio-economic benefits produced by the corporate veil would be lost.<sup>38</sup> Therefore, in most jurisdictions piercing the corporate veil is considered a last resource.<sup>39</sup>

### 1.2.1 Origins of the Doctrine of Piercing the Corporate Veil

The piercing of the corporate veil has its origins in the advent of the modern joint stock corporation. As mentioned in the first section, the joint stock corporation is considered a person, an entity with capacity to act in the legal world and to be liable. However, the corporate entity is not a creation of our times. The legal entity known as corporation was created in Europe during the Middle Ages but its use was limited to

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<sup>37</sup> Piercing the corporate veil is a remedy that has countered centuries of legal decisions that clearly state that the corporation is a separate legal entity and its owners are not responsible for debts or judgments against it. This remedy definitely undermines the corporate personality and the benefits it produces. See, Bevans, N. **Business Organization and Corporate Law**. U.S.A: Thomson Delmar Learning; 2007. At page 275

<sup>38</sup> The author Joel Moskowitz considers there is fear among small businesses in regard to the dramatic consequences of piercing the corporate veil. This fear is founded on losing all assets due to unlimited liability. This fear prevents investors from engaging in what may be considered risky enterprises. See, Moskowitz, J. **Environmental liability and Real Property Transactions**. 2nd Edition. New York: Aspen law & Business; 1995. At page 100-102

<sup>39</sup> See, Kraakman, R. & Others. **The Anatomy of Corporate Law; A Comparative and Functional Approach**. Oxford: Oxford University Press; 2009. At page 139

political and religious purposes.<sup>40</sup> During the Sixteenth and Seventeenth Centuries, the English and Dutch “chartered companies” received the attribute of legal personality and had their capital constituted in shares.<sup>41</sup> Although it could be considered a cousin of the modern joint stock corporation, the use of chartered companies was limited only to merchants that had political connections.<sup>42</sup> It was not until the Nineteenth Century with the advent of industrialization that the medieval corporation developed into the modern joint stock corporation.

To take a medieval institution such as the corporation and mould it into a commercial device was an English initiative. The industrialisation of manufacture created the need for large amounts of capital that few entrepreneurs could afford. The creation of partnerships was a solution to satisfy the needs of capital. However, the traditional partnerships lacked legal personality and involved high transaction costs as well as legal expenses.<sup>43</sup> Moreover, partners were exposed to the financial risk of the enterprise.<sup>44</sup> The creation of a type of business association with legal personality and limited liability for its members became necessary. Therefore, the first English

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<sup>40</sup> The first form of corporation was not created for the practice of commerce; rather it was created to protect the interests of monasteries and municipalities by the use of the advantages of legal personality, which would not be affected by sickness or death. The attributes of corporate personality helped to avoid complications such as the succession of assets; for example, in the case of a religious institution such as an abbey, if the abbot died the passing of the order’s land to the new abbot would discontinue. However, by conferring the legal personality to the abbey, this complication was avoided because as a fictitious entity it was not subject to mortality and was considered a person capable of owning property. Pope Innocent IV (in the 12<sup>th</sup> Century) was the individual who proposed the “fiction theory” in order to address the legal personality of the corporation. In the fiction theory, Pope Innocent IV addressed the corporation as an entity and gave the following definition:

“The corporation is a separate and distinct social entity, but its legal personality is a mere fiction conceded by the state or created by law”

Originally the corporate fiction was aimed at religious institutions but later the use of this entity was expanded to public institutions such as municipalities and universities. Consequently, a fiction created with a religious connotation gradually became a tool for political ends. See, Sesarego, C. *Naturaleza Tridimensional de la Persona Juridica*. *Revista de la Facultad de Derecho de la Pontificia Universidad Catolica de Peru*.(No 15) 1999. At page 2 - 5. See also, Brunetti, A. *Sociedades Mercantiles. Tomo I*. Colombia: *Editorial Juridica Universitaria*; 2002 At page 83. See also, Dewey, J. *The Historic Background of Corporate Legal Personality*. *Yale Law Journal*. (Volumme XXXV) 1926. At page 665-668

<sup>41</sup> See, Iwai, K. *The Nature of the Business Corporation: Its Legal Structure and Economic Functions*. <http://iwai-k.com/NatureofBusinessCorporation.pdf> [last visit 30 may, 2013] At page 5

<sup>42</sup> *Ibid*

<sup>43</sup> See, Micklethwait, J. and Wooldridge, A. *The Company: A Short History of a Revolutionary Idea*. U.S.A: Modern Library; 2003. At page 39 - 40

<sup>44</sup> Limited liability is not included in a partnership. In this type of association each partner is jointly and severally liable for the debts and obligations of the partnership while he or she is/was a partner. See, Digman, A. & Lowry, J. *Company Law*. 7th Edition. Oxford: Oxford University Press; 2006. At page 4

Companies Act was enacted in 1844.<sup>45</sup> It introduced the joint stock corporation as a type of business association with the attributes of legal personality. Shareholders' limited liability was a feature introduced later in 1855 with the Limited Liability Act.<sup>46</sup>

While the joint stock corporation was gaining relevance in England, in continental Europe other types of business association, which also included the attributes of legal personality and limited liability, were being developed. Examples are the French *Société Anonyme* (S.A),<sup>47</sup> the German *Gesellschaft mit beschränkter Haftung* (GMBH)<sup>48</sup> and the Spanish *Sociedad Anónima* (S.A)<sup>49</sup>. Certainly, the creation of a legal entity that confers limited liability was a breakthrough in countries experiencing the boom of industrialisation. However, with the introduction of the joint stock corporation (and comparable types of business associations in other jurisdictions) in the commercial context, abuse of the attributes of legal personality and limited liability also existed.

The idea of piercing the corporate veil originated in the courts of the U.S..<sup>50</sup> The U.S. is the jurisdiction that has substantially dealt with corporate personality issues.<sup>51</sup>

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<sup>45</sup> The 1844 Joint Stock Companies Act is the basis of the current U.K. framework for companies. This Act addressed basic aspects of the joint stock company such as: incorporation by simple registration, provided safeguards against fraud by insisting on full publicity and provided a Register of Companies to hold the public documents provided by the companies. See, *Idem*. At page 17

<sup>46</sup> The 1855 Act allowed the limited liability of members of a company as long as requirements were fulfilled. This Act established shareholder limited liability in its Section 8; "If any execution, sequestration or other process in the nature of execution, either at law or in equity, shall have been issued against the property or effects of the company, and if there cannot be found sufficient whereon to levy or enforce such execution sequestration or other process may be issued against any of the shareholders to the extent of their portions of their shares respectively on the capital of the company ...".

<sup>47</sup> The French *Société Anonyme* was introduced in the French Code of Commerce enacted in 1807. However, the attributes of legal personality and limited liability in addition to capital requirements were established in the *loi de mai de 1863* and the reforms in 1867.

<sup>48</sup> The German *Gesellschaft mit beschränkter Haftung* or limited liability company was introduced in Germany in 1892.

<sup>49</sup> In Spain the use of business associations became common during the colonial expansion (from Sixteen until Seventeen Century). However, the concept of corporate personality and limited liability became subject of interest in 1869 and 1885 when reforms to the Spanish code of commerce were made.

<sup>50</sup> A pioneer in the study of this legal phenomenon is the American author Maurice Wormser, who addresses this subject in his paper "the veil of the corporate entity". See, Figueroa, D. *Levantamiento del Velo Corporativo Latinoamericano; Aspectos Comparados con el Derecho Estado Unidense*. 1st Edition. Chile: Editorial el Jurista: 2011.

<sup>51</sup> Professor Robert Thompson, in an empirical study about the piercing the corporate veil, concluded that piercing of the corporate veil is one of the most litigated issues in Company law in the U.S.. In

This can be attributed to the relevant role that the corporate personality (first the chartered company and later the joint stock corporation) has played in the development of the infrastructure of the country.<sup>52</sup> The fact that the corporate personality became common use soon produced circumstances (fraud and tort liability) that triggered the question: to what extent should the veil of incorporation be preserved? The U.S. doctrine of piercing the corporate veil is the result of attempts to answer this question.

Although the idea of piercing the corporate veil originated in the U.S., its company law has not included a specific rule that allows its application. Rather, the piercing of the corporate veil has been applied through a standard developed from jurisprudence dealing with this issue. This standard requires the concurrence of three elements:

- Control by the shareholders over the company to the point that it cannot be considered an independent legal person
- Wrongful or fraudulent conduct by the part of the shareholders
- Connection between the excessive control over the company and the harm or loss suffered by the claimant

This standard has been addressed under the names of instrumentality and alter ego. However, the fact that corporate entity issues have been managed through a doctrinal

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his study, Thompson used a pool of 1,600 cases. He found that in 636 cases the veil had been pierced and that in 947 cases it had not. The 636 cases represent 40%, which can be considered a high figure if it is compared with other jurisdictions in which the veil is not frequently or never pierced. The Academic Peter Oh, two decades after Thompson's study, refreshes this subject with a new study based on 2,908 cases. He found that the veil had been pierced in 50% of the cases. Both studies included Federal and State Courts. Naturally, they classified the cases in accord to authority and type. However, for the purposes of this thesis I cite the general figures in order to support the statement regarding the American authorities' acceptance of a remedy such as piercing the corporate veil. See also, Thompson, R. **Piercing the Corporate Veil: An Empirical Study.** *Cornell Law Review.* (Issue 76) 1991. See, also, Oh, P. **Veil-Piercing.** *Texas Law Review, Vol. 89,* p. 81, 2010; U. of Pittsburgh Legal Studies Research Paper No. 2010-06. Available at SSRN: <http://ssrn.com/abstract=1557972> [last visit 8 august, 2013]

<sup>52</sup> See, Micklethwait, J and Wooldridge, A. *Supra note 43.* at page 57 -78

approach has been the subject of criticism by a sector of the U.S. academia and judiciary.<sup>53</sup>

The criticism of the mentioned standard has been based on the vagueness of the factors that compose it; for example, there is not a parameter to determine excessive control over a company nor is there a clear definition of what can be considered as fraudulent conduct in this context.<sup>54</sup> Therefore, the piercing of the corporate veil is a remedy that has been applied on a case-by-case basis, a factor that has generated uncertainty.<sup>55</sup> However, despite criticism, the U.S. doctrine of piercing the corporate veil has been a subject of interest for academics and judiciary in other common and civil law jurisdictions.

Currently, the idea of piercing the corporate veil has become universal. Moreover, academics and courts in different jurisdictions have used other terms to address the piercing of the corporate veil. In English, it has been addressed as *lifting / peeping behind* the veil, *penetrating* the corporate veil, or *ignoring* the corporate veil. In Spanish, it has been referred to as *levantamiento del velo corporativo*, *rasgado del velo corporativo*, *inoponibilidad de la persona juridical*. In Portuguese, it is regarded as *desconsideração da personalidade juridical* or *descortinamiento do véu corporativo*. Certainly these different terms in different languages make reference to the same remedy: the disregard of the legal entity in order to hold shareholders liable for the corporation. However, each legal system has individually developed its own method for dealing with corporate veil issues. The piercing of the corporate veil may be triggered by a circumstance that in other jurisdictions may not be regarded as a factor that could trigger the application of this remedy.

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<sup>53</sup> See, **Chapter Two**. At page 82-85

<sup>54</sup> See, Strasser, K. **Piercing the Veil in Corporate Groups**. *Connecticut Law Review*. (Issue 37). 2005. At page 645-646

<sup>55</sup> *Ibid*

### 1.2.2 The Reverse Piercing of the Corporate Veil

The occurrence of fraudulent behavior is the main trigger for piercing the corporate veil. However, the scope of this remedy has gradually expanded to cases that do not necessarily have a fraudulent element.

The scope of this research is the piercing of the corporate veil in the context of fraud. However, there are cases involving a compensation claim or tort damages in which the corporate personality has been disregarded without the occurrence of fraudulent behavior. I wish to briefly mention that currently the piercing of the corporate veil is not only practiced in the context of fraud since from this fact a phenomenon worthy of comment can be derived: “the *reverse* piercing of the corporate veil”. In a case involving the reverse piercing of the corporate veil, the affected party would not be a creditor; rather, the shareholders themselves would present the claim. In this type of case, the shareholders would seek to disregard the corporate personality when the corporate entity had become an obstacle for the shareholders to recover compensation from circumstances such as an insurance claim or expropriation by the government.<sup>56</sup>

The reverse piercing of the corporate veil has been controversial in the U.S., where courts have considered that “shareholders cannot have it both ways”.<sup>57</sup> Entrepreneurs, when trading under the corporate form, create a veil that they fiercely protect. They therefore cannot dispose of their veil whenever they see fit, as doing so would affect the integrity of the corporate personality.<sup>58</sup>

In other jurisdictions discussed in this thesis, England, Spain, Argentina, Colombia, Chile, Brazil and Panama, the reverse piercing of the corporate veil has not been an

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<sup>56</sup> The author Michael Gaertner defines the reverse piercing of the corporate veil as an attempt by shareholders, or the corporation itself, to pierce the corporate veil existing between the corporation and its shareholders. See, Gaertner, M. **Reverse Piercing the Corporate Veil: Should Corporation Owners have it Both Ways?** *William and Mary Law Review*. (Volume 30) 1989. At page 667

<sup>57</sup> See, *e.g.*, *In re Beck Indus.*, 479 F.2d 410, 418 (2d Cir.), *cert. denied*, 414 U.S. 858 (1973).

<sup>58</sup> See, Gaertner, M. *Supra note* 56. At page 682

issue. In the case of England, although English authorities are generally reluctant to ignore the corporate personality, in relevant cases such as *DHN Food Distributors v Tower Hamlets London Borough*<sup>59</sup> and *Smith, Stone & Knight v Birmingham Corporation*<sup>60</sup> judges have considered ignoring the corporate personality in favor of the shareholder owners (the facts of these cases will be presented in Chapter Two). As will be addressed in Chapter Two, English judges have different opinions regarding this subject. Whilst some judges are strictly in favour of the corporate personality, others may disregard it without considering whether the remedy is in favor of the shareholders or creditors. In Spain and Latin American countries, on the other hand, corporate personality issues are relatively recent and the dilemma of piercing the corporate veil has not considered whether shareholders can benefit from this remedy. In fact, some relevant corporate personality cases have been based on the reverse piercing of the corporate veil. Some examples shall be provided in Chapters Two, Three and Four, where the disregard of the corporate personality individually in each jurisdiction is addressed.

### 1.2.3 The Piercing of the Corporate Veil, a Private Law Remedy

This thesis regards the piercing of the corporate veil as a remedy applied in the context of private law. I consider in public law cases there is not a real piercing of the corporate veil. I support this statement on the rationale of public law, which is to regulate the relations between individuals and the state and also enforce public policies. In corporate veil cases where the State is a party and a public policy is in jeopardy, the concept of corporate personality is likely to be ignored.<sup>61</sup> An example is a case involving the policy aimed at the protection of public interest in free competition. To have free competition provides the consumer with better prices and entrepreneurs will look to improve the quality of their products. If the corporate personality is used to engage in monopolistic practices, it is used in a way whereby it is in detriment to public interest as the policy involved promotes free competition.

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<sup>59</sup> *DHN Distributors Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852

<sup>60</sup> *Smith, Stone and Knight Ltd v Birmingham Corporation*. [1939] B.C.L.C. 480

<sup>61</sup> In Chapters Two, Three and Four I emphasise and present cases that support this statement.

Monopolies produce an increase in product prices and innovation is limited.<sup>62</sup> Therefore, in order to enforce its policy regarding free competition, the state takes measures such as ignoring the corporate entity in order to sanction the thoughts that crafted a scheme aimed at creating a monopoly.

Courts in some jurisdictions have even established that corporate personality is irrelevant in public law cases. In Colombia, for example, the Colombian Supreme Court,<sup>63</sup> in dealing with a *Recurso de Casación Penal* involving an issue of a company used to hide assets product of illicit activities, came to the conclusion that for criminal law proceedings, the veil of incorporation does not has relevance.<sup>64</sup> It can be considered that this statement of the Colombian Supreme Court is one of the basis on which Colombian policy makers later developed the *Estatuto Anticorrupción* (addressed more extensively in Chapter Three). Another example can be found in Panama. In a case involving the use of the corporate entity to obstruct judicial enquires and to hide assets derived from illicit activities, the Panamanian Supreme Court of Justice concluded that the corporate personality is disregarded if it obstructs an investigation in which criminal proceedings depend (addressed in greater detail in Chapter Four).<sup>65</sup> Certainly, an academic or judicial authority may make reference to the concept of piercing the corporate veil in areas of public law such as criminal and tax law. However, no real corporate personality dilemma exists in this context since the corporate personality is likely to be ignored when it contradicts a public interest represented in a public policy.

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<sup>62</sup> In contemporary economics, monopoly is treated as a source of inefficiency. Lee, D & Mckenzie, R. **In Defense of Monopoly, How Market Power Foster Creative Production.** U.S.A: University of Michigan Press; 2008. At page 1

<sup>63</sup> The **Supreme Court of Justice** is the highest judicial body in civil and penal matters and issues of criminal and civil procedure in Colombia. The Supreme Court of Colombia is not the highest authority in regards to the interpretation of administrative law, constitutional law and the administration of the judiciary. The Court consists of twenty three magistrates, elected by the same institution in list conformed by the Superior Council of the Judiciary for individual terms of eight years. The Colombian Supreme Court is divided in five chambers (*Sala*): *Sala plena*, *Sala de Gobierno*, *Sala de Casacion Civil*, *Sala de Casacion Laboral* y *Sala de Casacion Penal*. <http://www.cortesuprema.gov.co/>

<sup>64</sup> “*El que para efectos comerciales y civiles la persona juridical sea un ente distinto de sus socios, es una verdad que no trasciende el ambito penal...*” See, *Corte Supreme de Justicia de Panama, Sala Penal, auto 7183 del 20 de enero de 1993*

<sup>65</sup> See, *Sentencia, Pleno de la Corte Suprema de Justicia. 29 de enero de 1991*

In contrast to public law cases, in private law cases the political state is not a party. The concept of private law makes reference to the area of law that usually deals with the relationships between individuals that are of no direct concern of the state.<sup>66</sup> The modern concept of corporate personality was created mainly for commercial purposes and the piercing of the corporate veil was originally created to address issues that derived from the relationship among private individuals (the corporation and other traders). The dilemma about whether or not to ignore the corporate personality was triggered because the fact that an individual requests the court to ignore the corporate personality demands the judge to omit a policy that is aimed at economic welfare. Common and civil law jurisdictions recognise and tend to preserve the corporate entity as part of a policy aimed at economic development. This fact is justified with the objective of the corporate personality; to encourage investment by diminishing the risks that involve every commercial adventure. This objective is achieved by transferring the risk to creditors and tort victims. Undeniably, a degree of unfairness exists but the corporate entity is part of a development policy that is supposed to benefit economic welfare. On the other hand, it cannot be said that there is not a public interest in an individual's claim to pierce the corporate veil. In this context, the public interest lays in preventing and punishing the wrongful use of the corporate entity. However, to trade using the benefits of the corporate personality tends to produce unfair situations for creditors, tort victims and in some cases to shareholders, which are not necessarily derived from the wrong use of the corporate personality. Therefore, different approaches (addressed later in Chapters Two and Three) to deal with corporate veil issues have been developed in order to determine whether the policy supporting the corporate personality should be ignored or not. In other words, the interest of an individual (or a small group) has to be balanced against a public interest represented on the policy that supports the existence of the corporate personality.

The corporate personality has not only been discussed in the context of commercial relationships but also in the context of family and labour law. Family and labour law deal with relationships between private individuals and consequently the first thought would be that these two areas are part of the private law 'branch'.

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<sup>66</sup> See, Martin, E. **A Dictionary of Law**. 6th Edition. Oxford: Oxford University Press; 2006

However, there is a strong public interest that makes the piercing of the corporate veil more likely in these two areas than in commercial law. The public interest lies in the fact that in modern societies, aspects regarding children's and workers' rights have gained relevance. In family law, a common misuse of the corporate entity has been the use of the corporate entity as a means to hide assets that are part of a matrimonial regime in order to avoid the distribution of those assets. In labour law, the corporate veil (in some circumstances) obstructs workers from receiving compensation because the corporate entity has run out of assets and shareholders have had their liability limited to their share in the company.

The jurisdictions studied in this thesis have adopted a similar position about the corporate personality in family and labor law; they generally ignore the corporate personality in this context. Later in Chapters Two, Three and Four, it can be noted that relevant precedents in this subject have been developed in family and labor law.

The Latin American jurisdictions studied in Chapter Three are those that have dealt with corporate personality issues in a more substantial manner. Moreover, these jurisdictions have introduced an exception to the corporate personality in private law statutes. In England, the U.S. and Spain, the piercing of the corporate veil has also been addressed from a private law perspective. The fact that exceptions have been drafted in the context of private law strengthens my notion of piercing the corporate veil as a private law remedy.

It cannot be denied that in modern common and civil law jurisdictions, in public law statutes such as tax law, bankruptcy law and environmental law, direct exceptions to the corporate personality have been introduced. As previously mentioned, I personally do not see a real dilemma regarding the piercing of the corporate veil in this context. However, the existence of a direct exception in a public statute is, I believe, to "emphasise the priority of a public interest". This thesis focuses on the piercing of the corporate veil in a private law context for reasons already explained. Nonetheless, in Chapters Two, Three and Four some public law statutes (such as tax law, environmental law and bankruptcy law) have been included as they contain exceptions to the corporate personality. The inclusion of these statutes is to provide

evidence of my thought regarding the tendency of the state (in civil and common law countries) to ignore the corporate personality when a public interest is at stake.

The function of the state is to protect the public's interest.<sup>67</sup> Consequently, a fiction like the corporate personality created for the interest of a small group of individuals will not be protected by the state if this is used against public interests.

### **1.3 The Effect of Piercing the Corporate Veil over Aspects of the Modern Corporate Personality**

The concept of piercing the corporate veil has been explained together with its roots in the concept of corporate personality. However, I cannot omit the fact that the concept of corporate personality is not what it used to be in its early days. This concept has changed together with markets and commercial practices. Without doubt, the piercing of the corporate veil has also been present throughout this process of change and generated debate in modern aspects of the corporate personality such as corporate groups and private and public companies.

#### **1.3.1 The Piercing of the Corporate Veil in the Context of Corporate Groups**

A corporate group is not a new company nor has it legal personality.<sup>68</sup> It is a concentration of companies that may be the result of different circumstances such as the creation of new companies, international mergers or joint ventures.<sup>69</sup> A corporate group can be defined as two or more companies that operate under a similar directive in order to achieve a common objective.

Each company that is part of the group has a legal personality and independent existence. However, in order to achieve the common objective, the companies forming the group accept operating under the direction of a parent company that establishes the policies and the strategy that the subsidiaries have to follow.

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<sup>67</sup> I regard the protection of public's interest as one of the functions of the state and public policies are a means to perform this duty.

<sup>68</sup> Eisenberg, M. **Corporate Groups**. Gillooly, M. **The Law Relating to Corporate Groups**. Australia: The Federation Press; 1993. At page 2- 7

<sup>69</sup> *Ibid*

Traditional company law has been the subject of criticism because it tends to apply the same rules of a natural person shareholder to the corporate entity in its role as a shareholder.<sup>70</sup> This lack of distinction can be attributed to the fact that in the early days of the joint stock corporation only natural persons had the right to be shareholders; a company was not allowed to own shares of another company.<sup>71</sup> Therefore, company law was developed as a body of law to deal with companies formed by individual investors. Moreover, early cases involving the disregard of the legal entity were based on making a natural person liable for the debts of the company.<sup>72</sup> It was not until the late Nineteenth Century that companies were allowed to own shares of another company.<sup>73</sup>

The role of a corporate entity as a shareholder tends to differ from the role of the natural person shareholder. On the one hand, the corporate entity is not an individual investor; rather it is a group of investors that trade under the corporate form. Moreover, a parent company creates, operates and dissolves subsidiaries primarily as part of a business strategy in pursuit of the business goal of the larger enterprise, which the parent and all the subsidiaries are pursuing together. On the other hand, a natural person as a shareholder is an individual investor that seeks to profit from its investment and whose role may be passive or active regarding the companies' management.

Currently, when corporate groups operate through a network of subsidiaries organised under the laws of many different states; they are referred to as multinational

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<sup>70</sup> The author Philip Blumberg considers that limited liability for corporate groups emerged from an historical accident. The author considers that the application of liability to insulate from liability parent corporations as well as ultimate investors apparently occurred unthinkingly as a consequence of the recognition of the separate legal entity of a corporation from its shareholders. He considers there was no consideration over the aspects that involve a parent-subsidiary relationship. See, Blumberg, Ph. **Accountability of Multinational Corporations: the Barriers Presented by Concepts of Corporate Juridical Entity.** *Hastings International and Comparative Law Review.* (Issue 24). 2001. At pages 207 to 304. See also, Fuentes, C. **Acercamiento al Concepto de Grupos Empresariales: Concurrencia de Elementos para su Existencia.** *Revista e-Mercatoria,* (Vol. 8, No. 1) 2009. Available at SSRN: <http://ssrn.com/abstract=1493764> [Last visit 30 may, 2013]

<sup>71</sup> See, Blumberg Ph, *Ibid*

<sup>72</sup> See, Blumberg Ph, *Ibid*

<sup>73</sup> Corporate groups emerged in the U.S. with the liberalisation of state corporation laws. The first state that authorised corporations to acquire and own shares of other corporations was New Jersey in 1889. See, Blumberg, Ph. **The Corporate Entity in an Era of Multinational Corporations.** *Delaware Journal of Corporate Law.*(Volume 15) 1990. At page 325

enterprises.<sup>74</sup> Moreover, nowadays the corporate group is the dominant form of enterprise organisation in the largest worldwide markets.<sup>75</sup> The popularity corporate groups have gained also makes corporate veil issues more common in this context.

As has been mentioned, a corporate group is not a new company with legal personality; each company that is part of the group is an independent legal entity.<sup>76</sup> The relationship between the parent company and the subsidiary derives from the parent company's role as shareholder of the subsidiary. Consequently, the parent has liability limited only to the extent of its contribution in the corporation assets. The piercing of the corporate veil has been applied to establish a parent company's liability for its subsidiary.

The following parameters are used to determine a parent company's liability: the degree of control of the parent company over the subsidiary, the non-compliance with corporate formalities and the lack of the subsidiary's independent objective. These can be considered as universal parameters.<sup>77</sup> The control of the parent company over the subsidiary varies depending on the type of activity and business strategy; for instance, to hold a parent company liable on grounds of control might be a difficult task. Therefore, this argument must be supplemented with other circumstance such as a lack of compliance with corporate formalities.

I divide corporate formalities into two types: formalities for incorporation and management formalities. On the one hand, formalities for incorporation are the legal formalities established in company law that must be adhered to in order to create a company. The disregard of the legal entity does not apply in this context because if

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<sup>74</sup> Vandekerckhove, K. **Piercing the Corporate Veil**. The Netherlands: Kluwer Law International; 2007. At page 5

<sup>75</sup> *Ibid*

<sup>76</sup> However in the case DHN Foods distributor, Lord Denning challenge this notion of corporate groups. See, **Chapter Two**. At page 51

<sup>77</sup> An example to support this statement is in the cited English case *Smith, Stone and Knight Ltd v Birmingham Corporation* and the Argentinean Case *Cia. Swift de la Plata Sa S/ Quiebra C/ Deltec Arg. Y Deltec Internacional*. These two cases happened in different jurisdictions. Moreover, both jurisdictions follow a different legal tradition. However, courts in both countries regarded control of the parent company over the subsidiary, the non-compliance with corporate formalities and the lack of the subsidiary's independent objective in order to decide whether or not to ignore the corporate personality. I used only two examples, but later in Chapters Two and Three I address cases in other jurisdictions in which this set of factors have been used to deal with corporate groups in this context. See, **Chapter Two** at page 49 and **Chapter Three** at page 138

the legal requirements are not followed, the company would not exist. Management formalities, on the other hand, are the formalities that must be adhered to by the company's managers and shareholders.

Management formalities, such as the lack of accountability registers and lack of records regarding the board of directors' meetings, may be determinant to pierce the corporate veil in the context of corporate groups.<sup>78</sup> The lack of accountability register may create confusion between the finances of the parent and the subsidiary companies while the lack of a record of meetings may give grounds to deduce that the subsidiary has not an essential organ (director's board) for its legal performance. The lack of compliance with management formalities may create grounds to consider that the subsidiary is not an independent legal person. In addition, as a company the subsidiary has to have a specific objective established in the Articles of Association. Certainly, this can be regarded as part of the formalities for incorporation. However, although the objective of the subsidiary is established in the Articles of Incorporation this (in some circumstances) is not followed. In the context of corporate groups, a subsidiary that lacks an objective independent from that of the group cannot be regarded as a legal person. The lack of an independent objective can be considered to have derived from the excessive control of the parent company over the subsidiary. Later, in Chapters Two and Three, it can be appreciated that the courts in the common and civil law jurisdictions subject of this study have considered these factors in order to shape their decision over a parent company's liability case.

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<sup>78</sup> *Idem*, at page 20-23

### 1.3.1.1 Single economic unit

The fact that the corporate group is based on multiple legal entities acting as a single unit gives rise to another means to deal with a parent company's liability, which has been addressed as a "single economic unit". The single economic unit is a tool that can be used to ignore the corporate personality. This is based on the fact that a group of companies act as a unit in order to achieve a common objective and consequently should answer as a unit for the obligations of the members of the group.

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The single economic unit can be considered as a means to deal with the group structure and may differ from the traditional piercing of the corporate veil. Certainly, by disregarding the legal personality of the companies forming the group, a sole unit is rendered. However, a single economic unit does not depend on the concurrence of factors required as standard; rather, a single economic unit usually occurs for purposes of the interpretation of a statutory rule or contractual clause.<sup>80</sup> Moreover, the application of the single economic unit approach tends to be straightforward because the statutory rule or contract clause may have been drafted without considering the principles on which the structure of the corporate group is founded.<sup>81</sup>

### 1.3.2 The Corporate Veil in the Context of Private and Public Companies

The corporate entity can exist as a private company or public company. A private company is one whose shares do not trade freely in impersonal markets and are owned by a small number of persons.<sup>82</sup> A public company, on the other hand, is a company whose shares are offered in a capital market to the public.<sup>83</sup> In the U.S., England and Spain, public companies are part of business culture. These countries have gradually developed capital markets in which corporate entities can participate. In Argentina, Colombia, Chile, Brazil and Panama, however, the growth of public companies is quite recent. Latin America is a region that has started to experience

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<sup>79</sup> See, Cheng, T. **Piercing the Corporate Veil Across the Atlantic: A Comparative Study of the English and the U.S. Corporate Veil Doctrines.** Available at: [http://works.bepress.com/thomas\\_cheng/3](http://works.bepress.com/thomas_cheng/3) [last visit 30 may, 2013] at page 4 - 15

<sup>80</sup> See, Vandekerckhove K, *Supra note 74.* at page 5

<sup>81</sup> *Idem*, at page 6

<sup>82</sup> See, Kraakman, R. & Others. *Supra note 39.* At page 2

<sup>83</sup> *Ibid*

economic growth since the late 1980s. Before this period, capital markets were small or non-existent in the region. Consequently, public companies are not part of business culture in Latin America and thus corporate entities are commonly private.<sup>84</sup>

The disregard of the legal entity is a remedy aimed at making shareholders liable for the acts of the corporate entity. In order to apply this remedy, the concurrence of fraudulent behavior on the part of the shareholders is required. Certainly, the fraudulent shareholder must have a degree of control over the company's management in order to achieve its fraudulent purpose. This degree of control is commonly achieved in privately owned companies in which shareholders tend to have an active role in management. In fact the relevant cases dealing with corporate veil issues (which I present later in this thesis) in the U.S., England, Spain, Argentina, Colombia, Chile and Brazil have involved privately owned companies rather than public companies.

This does not mean that the disregard of the legal entity cannot be applied to companies that go public. However, it is not common. The shareholders of a public company tend to have a passive role regarding management. The daily management of the company is a task performed by hired professionals who make up the directors' board.<sup>85</sup> Consequently, directors will face liability if the company defaults due to negligence, reckless management or fraud.<sup>86</sup> Certainly the corporate entity has personality and assets different from those of the directors. However, hired directors may not be shareholders. Consequently, they may not reap the benefits of the corporate veil. Corporate governance standards, accountability regulations and insolvency laws are some of the methods used to deal with the directors who are responsible for the performance of the corporate entity.

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<sup>84</sup> See, Reyes, F. **A new Policy Agenda for Latin America Company Law: Reshaping the Closely-Held Entity Landscape.** University of Tilburg. 2011. Available at <http://arno.uvt.nl/show.cgi?fid=115302> [Last visit 13 june, 2013] At page 15

<sup>85</sup> Clarke, T. **Corporate Governance: Comparative approach.** U.S.A: Routledge; 2007. At page 33-37

<sup>86</sup> *Ibid*

## 1.4 The Influence of Legal Tradition over the Piercing of the Corporate Veil

The legal tradition followed by a country is an influential factor in the development of an approach to deal with corporate personality issues. The concept of legal tradition makes reference to a set of customs and practices used by society to deal with issues among its members.<sup>87</sup> In modern civilization the common law and the civil law are the most influential legal traditions due to historical factors.<sup>88</sup> The legal tradition establishes the basic rules and principles that the judiciary will follow when dealing with legal issues. However, each society has different legal needs, thus each will use the rules and principles of the legal tradition in accord to these internal needs. From a legal tradition, a legal system is created and this in turn creates the environment in which concepts such as piercing the corporate veil are going to be developed.

In this thesis it is argued that Latin American countries have developed their own approaches to pierce the corporate veil, rather than borrowing the American doctrine. This statement derives from the fact that there is a misconception regarding the piercing of the corporate veil. Indeed, some Latin American academics consider that the American doctrine of piercing the corporate veil has made its way to Latin America.<sup>89</sup> I cannot deny the fact that the American doctrine of piercing the corporate veil has been a subject of interest for Latin American academics and judiciary.<sup>90</sup>

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<sup>87</sup> The author, Patrick Glenn, in his work “Legal Traditions of the World” explores the concept of tradition and its influence on current legal practice. He focuses on aspects such as customs, religion and regional practices as the basis of current legal traditions. See, Glenn, P. **Legal Traditions of the World** (4th Edition). New York: Oxford University Press; 2010

<sup>88</sup> There are other legal traditions such as Islamic legal tradition and Hindu legal tradition. However, the civil and common law traditions are currently the prevalent legal traditions due to factors such as colonial expansion of European empires. Powerful European countries such as the U.K., Spain and France, exported the common law and the civil law tradition to different regions of the world. After the colonies gained independence, they kept the legal traditions introduced by the colonising countries. As a result we have common and civil law as the most relevant legal traditions. See, *idem*. At page 361

<sup>89</sup> The author, Jose M. Bello, in his paper regarding the piercing of the corporate veil in Latin America, considers the piercing of the corporate veil as a concept loaned to Latin American jurisdictions. He states that “the doctrine of piercing the corporate veil has been trying to make its way through Latin America.” This is a statement which is not shared in this thesis, due to the fact that the corporate personality is a universal concept. A point addressed later in more extent.

See, Bello, J. *Supra note* 26. At page 628

<sup>90</sup> The authors Perez and Diaz are some of the Latina American academics that have developed an interest on the study of the American doctrine of piercing the corporate veil. Perez, R. **Una Vision**

However, the Latin American countries that have introduced an exception to the corporate personality have structured this in accordance with the principles and internal beliefs of the civil law tradition.<sup>91</sup> The relevance that legal tradition has had over the development of piercing of the corporate veil in different jurisdictions is one of the core points addressed in this thesis. This point is one of the aspects on which my research question has been structured.

### **1.5 The Principle of *Sana Critica*; how does it fit in this context?**

The civil law is a legal tradition that adheres to the strict application of statutory rules for the sake of legal certainty; to confer judges with judicial discretion is against the basis of the civil law tradition.<sup>92</sup> However, throughout the Twentieth Century the civil law tradition has been in the process of becoming more flexible. Indeed, the law that composes the legal framework of civil law tradition countries can be compared to a raw material that needs to be processed in order to properly use it. Positive law is a human creation and is consequently imperfect. Positive law has loopholes and undefined concepts; policy makers cannot predict all series of circumstances that may concur on a legal dispute. Thus, the *Principios Generales del Derecho* (legal principles) appear as the means to process positive law and make it suitable to society's legal needs. Legal principles can be used for this task because they are composed of a series of principles with the aim of the fair administration of justice. The principle of *sana critica* is part of this group of legal principles and can be defined as a principle that encourages legal reasoning. *Sana critica* is a tool for the interpretation of law that is based on rules that support the use of common knowledge and logic. Indeed, *sana critica* helps the rational application of positive law by providing the civil law judge with the ability to critically assess the facts of the case.

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**Dual de la Doctrina del Levantamiento del Velo de la Persona Juridica.** *Revista del Instituto de la Judicatura Federal* No 25. 2008. See also Diaz Olivo, C. **Mitos y Leyendas Acerca de la Doctrina de Descorrer el Velo Corporativo.** *Revista Juridica de la Universidad de Puerto Rico* (Volume 73: No. 2) page 311-91. 2004

<sup>91</sup> The civil law tradition is characterised for its formalist nature, which contrasts with the flexibility of the common law. In Chapter Three I will address aspects of the civil law tradition that have influenced the piercing of the corporate veil in Latin American jurisdictions.

<sup>92</sup> Perdomo, R. & Marryman, j. *Supra note* 17. At page 48

In this thesis, I have turned my attention to the principle of *sana critica*, rather than looking to traditional concepts already used by other Latin American civil law jurisdictions to deal with the corporate personality. In order to deal with corporate personality issues the substance rather than the form must be examined and for this task legal reasoning is required. I consider *sana critica* can provide the necessary support for the proper application of piercing the corporate veil in a civil law country such as Panama. I support this belief on the fact that *Sana critica* is composed of a set of rules that I address as “rules of critical thinking”. These rules allow a degree of discretion but at the same time prevent personal bias (I will address each of these rules and their potential role in Chapter Five).

## **Chapter Conclusion**

The corporate entity was a perfect invention. Indeed, it allows the rise of capital to support ambitious enterprises. However the entrepreneur that uses that vehicle often found ways of misusing it, particularly for fraud. The advent of corporate groups and the increase in the use of the corporate personality have both made corporate veil issues more common. Thus, the existence of a remedy such as the piercing of the corporate veil has become necessary. However, it cannot be ignored that the piercing of the corporate veil is a remedy developed individually by each jurisdiction in accord to its internal and legal needs. The individuality of each jurisdiction in this context and the influence of legal tradition are the basis on which I have structured my research question. In the following chapters evidence of each jurisdiction’s individuality and influence of legal tradition will be provided.

## **CHAPTER II: The Doctrine of Piercing the Corporate Veil in England and the U.S**

As mentioned in the first chapter, the piercing of the corporate veil is originally an Anglo-American doctrine. The fact that England and the U.S. were the first to use the corporate personality as a device for commerce, they were thus first to experience the dilemma about whether or not to pierce the corporate veil. The focus of this research is to study the piercing of the corporate veil in Latin American civil law jurisdictions. Certainly, a different setting from that presented in common law jurisdictions such as England and the U.S.. However, the piercing of the corporate veil is originally an Anglo-American remedy and consequently a study of the way in which the corporate veil has been dealt in these jurisdictions is imperative.

The U.S. and England are both common law tradition countries. This legal tradition, which combines the applications of rules of common law and equity, allows the judge to use critical thinking when the positive law does not provide an answer to an issue or its strict application may produce an unfair result. This has been a great aid for common law judges when dealing with corporate personality issues. Indeed, in England and the U.S. no direct exception to the corporate personality has been introduced. Therefore, when an issue involving the corporate personality has arisen, the common law judge has used his power to personally assess whether to ignore or preserve the statutory rule supporting the corporate personality. As a result, case law regarding piercing the corporate veil contains a diversity of opinions regarding this subject. From case law, doctrinal approaches to deal with corporate personality issues have been developed. However, although England and the U.S. follow the same legal tradition and additionally critical thinking has been key to deal with corporate veil issues, the piercing of the corporate veil has been addressed differently in both jurisdictions. In this chapter, besides general aspects of piercing the corporate veil, the path that each jurisdiction has taken regarding the application of this remedy will be addressed. Moreover, a personal analysis about the factors that have contributed to a

different application of piercing the corporate veil in England and the U.S. shall be presented.

## 2.1 Piercing the Corporate Veil in England

Disregard of the legal entity has been a controversial subject in English company law. In fact the English judiciary has been characterised for being less willing to pierce the corporate veil than has the U.S..<sup>93</sup> The perception of England as a jurisdiction willing to preserve the corporate personality can be attributed to the fact that less direct approaches to deal with corporate veil issues have been applied by English courts. However, before addressing the methods used by the English judiciary to deal with corporate veil issues, I will proceed to address the case *Salomon V. Salomon Co. Ltd*, which can be considered the precedent that created the foundation of the current position of the English courts with regard to the piercing of the corporate veil.

### 2.1.1 The case of Salomon

English company law authors regard the case of *Salomon V. Salomon Co. Ltd*<sup>94</sup> as the landmark in the preservation of the corporate entity's integrity and autonomy.<sup>95</sup> This precedent created the foundations of the current position of the English judiciary in regard to the corporate personality.

This case presented an early and I dare to say simple scenario, if compared to the modern corporate structures. Mr. Aron Salomon was a boot maker, who carried out his business as a sole trader. One day he decided to enjoy the benefits of limited

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<sup>93</sup> See, Cheng, T. *Supra note 79*. At page 3

<sup>94</sup> *Salomon V Salomon & Co* [1897] A.C. 22

<sup>95</sup> The case of *Salomon* has been perceived by academia as a landmark of the corporate personality in England. The author, Susan Barber, states that "In the study of company law it is essential to understand the essential facts and issues of the case; this is the most fundamental decision of the courts in this field." The author, Eilis Ferran, argues that "An incorporated company is a legal persona separate and distinct from the people who hold shares in it and the people who manage it. This has been a foundation stone of company law in the UK ever since the decision of the House of Lords in *Salomon v Salomon & Co Ltd*." The authors Grantham & Rickett point out that the case of *Salomon* "is credited with having articulated the founding propositions of company law, and it is accordingly treated by judges and academics alike with a reverence bordering on the religious." See, Barber, S. **Company Law**. 4th Edition. Great Britain: Old Bailey Press; 2003. At page 5. See, Ferran, E. **Principles of Corporate Finance Law**. New York: Oxford University Press; 2008. At page 14-15. See, Grantham, R. & Rickett, C. *Supra note 29*. At page 3

liability and created a company called “*A Salomon & Co Ltd*”, to execute the bookmaking business. The members of the company were his wife, his daughter, four sons and himself. Each subscriber took a £1 share. Mr. Salomon sold his boot making business to the company for £39,000. Part of the purchase price was used by Mr. Salomon to subscribe for a further 20,000 £1 shares in the company. However, £10,000 of the purchase price was not paid by the company; rather this was given to Mr. Salomon in a series of debentures, which in turn gave Mr. Salomon a guarantee for the debt. In other words, he had preference over other creditors in case the company defaulted, which is indeed what happened. The business of *A Salomon & Co Ltd* failed, and the company went into liquidation. As a creditor with preference, Mr. Salomon claimed for his credit. However, this payment would have left the company without enough assets to cover debts to other creditors. Consequently, Mr Salomon’s claim was challenged by the company’s liquidator, who claimed that Mr. Salomon should answer for the debts of the company. The plaintiff argued that the company had conducted the business as an agent of Mr. Salomon and consequently he was responsible for the debts incurred in the course of the agency. The First Instance Court decided in favour of the plaintiff. Therefore Mr. Salomon appealed. Although *Salomon & Co* was properly incorporated, the Court of Appeal considered this fact not to be relevant.<sup>96</sup> Instead, the Court of Appeal focused on whether the sale of Mr. Salomon’s business to *Salomon & Co* was valid; should this transaction be supported to enable Mr. Salomon to defeat the creditors and under the debentures appropriate the assets to himself?<sup>97</sup>

Based on the facts of there not being a valuation of stock, account of profits and non- influential members of the company (shareholders were considered as dummies used by Mr. Salomon to comply with a statutory requirement), the Court of Appeal decided that *Salomon & Co* was a sham created by Mr. Salomon to defeat creditors.<sup>98</sup> Therefore, the remedy provided by the Court of Appeal consisted of two options: (1) Mr. Salomon had to indemnify the company against the debts and costs; (2) or the Court could declare the sale of the business as invalid, set aside the agreement and

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<sup>96</sup> See, *Broderip v Salomon* [1895] 2 Ch. 323. At page 334

<sup>97</sup> See, Kay L.J comments. *Idem*. At page 347

<sup>98</sup> See, Lindsay L.J comments. *Idem*. At page 337

debentures and order Mr. Salomon to repay the money of the sale.<sup>99</sup> Certainly, both options were aimed at setting aside the corporation's legal personality and made Mr. Salomon liable for the debts of the Company.

The House of Lords, however, rejected the decisions made by the First Instance Court and the Court of Appeal. The existence of *Salomon & Co Ltd's* personality was preserved. Their Lordships held that there was nothing in the Companies Act that prohibited what Mr Salomon had done, Lord Macnaghten, Lord Halsbury and Lord Herschell:

*“It is not contrary to the true intent and meaning of the Companies Act 1862 for a trader, in order to limit his liability and obtain the preference of a debenture-holder over other creditors, to sell his business to a limited company consisting only of himself and six members of his own family, the business being then solvent, all the terms of sale being known to and approved by the shareholders, and all the requirements of the Act being complied with.”*<sup>100</sup>

The decision made by the House of Lords in the case of Salomon, indeed, defined the effects of the corporate entity.<sup>101</sup> It was established that the mere wish to trade using the corporate entity in order to get the benefits of limited liability is not itself to be regarded as fraud.<sup>102</sup> The whole purpose of incorporating a business is for its member[s] to avoid incurring further personal liability.<sup>103</sup> To presume the creation of a company as fraudulent would defeat the whole notion of the separate existence of the company and make it impossible for small private companies to function in a different way to partnerships. However, it was clear from the decision in Salomon that had there been evidence of fraud their Lordships would not have recognised the company as a separate entity.

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<sup>99</sup> See, *Idem*. At page 347

<sup>100</sup> See, *Supra note* 94. At page 1

<sup>101</sup> See, Mayson, French & Ryan. **Company Law**. Oxford: Oxford University Press; 2010. At page 124, at paragraph 5.2.2

<sup>102</sup> See, Dine, J. **Company Law**. 7th edition. Basingstoke: Palgrave Macmillan; 2009. At page 24

<sup>103</sup> See Lord Watson comments in *Salomon v Salomon & Co.* [1897] A.C 22. At page 35

In addition, in the Salomon Case, it was clarified that being a controller member of a company does not in itself make the company an agent of that member, (although the sole objective of the company is to benefit the member[s]).<sup>104</sup> Consequently, the creditors that accept trading with a corporate entity also accept the risk that should the company default they cannot reach the shareholders assets. Therefore, creditors have the obligation to establish adequate protections to have a higher probability of recovering their credit in case of default.<sup>105</sup>

### 2.1.2 The Effects of the Salomon's Precedent

Based on the precedent of Salomon, the English judiciary has established that the only condition to enjoy the benefits of the corporate entity is that the company be properly created by registration. The Companies Act 2006 give the register power to refuse to register a company not created for a lawful purpose. In principle, the English judiciary will not allow the use of the corporate entity for fraudulent purposes. However, the piercing of the corporate veil is not common in this jurisdiction. I personally consider that the English approach to corporate personality cases involve an extension of liability rather than piercing the corporate veil. As will be shown throughout this section, the English judiciary has opted for not affecting the integrity of the corporate personality.

Certainly, since the decision on the Salomon case English authorities have crafted exceptions to the corporate personality. These main exceptions have been developed under the concepts of “sham”, “agency” and “single economic unit”. However, although these exceptions are currently valid and applicable, none of these have been widely applied.

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<sup>104</sup> See, Mayson, French & Ryan. *Supra note* 101. At page 133, at paragraph 5.3.6.1

<sup>105</sup> Lord Watson in his comments held that “...in my opinion, a creditor who will not take the trouble to use the means which the statute provides for enabling him to protect himself must bear the consequences of his own negligence.” See, *Supra note* 94. At page 40

### 2.1.2.1 Sham Exception

The Case *Gilford Motors v Horne*,<sup>106</sup> is an early corporate personality case on which the obligations of a natural person are extended to a corporate entity and it is justified through an argument based on the concept of sham. In this case, the defendant was accused of using a company called “JM Horne & Co Ltd” to avoid the effects of a covenant to not compete with his ex-employer. The defendant did not hold shares or a position in the company. Instead, his wife and an employee held shares and were the directors of the company. However, the defendant had a strong influence over the management of the company. Therefore, based on the fact that Mr. Horne sought to avoid the covenant through a company (that he indirectly controlled) the court considered the company to be a “mere cloak or sham”.<sup>107</sup> It was believed that even if a company was properly incorporated, its legitimacy would be doubted if it were suspected of being a device to conceal an illegitimate purpose. However, the outcome of this case was not the piercing of the corporate veil. Rather the effects of the covenant were extended from Mr. Horne to the Company JM Horne & Co Ltd, and the integrity of the corporate personality was preserved.

The precedent established in *Gilford Motors v Horne* created the basis for the concept of sham to become an available argument against wrongdoers who sought cover behind the corporate personality. In the case *Jones v Lipman*,<sup>108</sup> the argument of sham established in *Gilford Motors v Horne* was again used to deal with the fraudulent use of corporate personality. In this case the defendant agreed to sell some land but later he decided not to complete the sale. The defendant decided to transfer the property to a company, of which he and his lawyer were the shareholders and directors. The court regarded this company as “the creature of the defendant, a device, a sham”.<sup>109</sup> However, rather than piercing the corporate veil, the court decided to make the company a second defendant. Furthermore, both defendants were obligated to complete the agreement between the claimant and the first defendant.

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<sup>106</sup> *Gilford Motor Co V Horne* [1933] Ch. 935

<sup>107</sup> See, *Gilford Motor Co V Horne* [1933] Ch. 935, Lawrence L.J comments at Page 965

<sup>108</sup> *Jones v Lipman* [1962] 1 W.L.R

<sup>109</sup> See, *Jones v Lipman* [1962] 1 W.L.R Russel J comments at page 836

Although the outcome of the cited cases did not result in the piercing of the corporate veil, it can be considered that the relevance of both precedents derived from the fact that the scope of the sham exception was defined. Indeed, from this point the judiciary started to consider that the use of the corporate entity as an instrument to escape contractual obligations is a justification to set aside the corporate personality. However, the concept of sham derived from *Gilford Motors v Horne* can be regarded as an incomplete approach because there is not a systematic procedure or set of factors that help to determine whether or not to pierce the corporate veil. Indeed, from the cases *Gilford Motors v Horne* and *Jones v Lipman* the judiciary did not create a method to properly apply this approach, a fact that can be attributed to the concern regarding the principle established in the case of *Salomon*.

However, despite the lack of a systematic method, case law has made the English judiciary consider the concurrence of facts such as the motive for creating a company. The motive can be determined on there being a criminal component or an intention to defraud. Moreover, the exact moment as to when a company is brought into being is also considered as it helps to define the intention of the incorporator(s); for example, if a person creates a company and then transfers its assets, which are part of legal proceedings, the legitimacy of this legal entity may be regarded as doubtful and thus be considered a sham.

In more contemporary English corporate personality cases, parties seeking to pierce the corporate veil have continued to make use of the concept of sham. An example is the the case, *Trustor AB v Smallbone & others*.<sup>110</sup> In the case *Trustor AB v Smallbone & others*, Mr. Smallbone is a director accused of syphoning funds. He had authority to administrate Trustors AB monies and using its power transferred the monies to a company called Introcom. Introcom was a company controlled by Liechtenstein Trust, whose beneficiary was Mr. Smallbone. In this case, the claimant argued that the company was a sham used for improper purposes. Certainly the English court considered setting aside the corporate personality and holding Mr. Smallbone liable. In this case the court held “... the court is entitled to pierce the corporate veil and recognise the receipt of the company as that of the individual in control of it if the company was used as a device or façade to conceal the true facts,

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<sup>110</sup> *Trustor AB v Smallbone* [2001] 2 BCLC 436

thereby avoiding or concealing any liability of those individual(s).”<sup>111</sup> However, although the improper use of the corporate entity was recognised, it was not considered to be sufficient justification to pierce the corporate veil.

The concept of sham can be considered as an appropriate basis from which to develop an argument to deal with the corporate personality when used for improper purposes. Nonetheless, since its early days this approach has been covered by the shadow of the precedent established in the case of Salomon. The three cited cases present three different periods of time and it can be appreciated that although there is an evident improper use of the corporate personality, the English courts have opted for keeping the integrity of the corporate personality and deal with the issue through alternative means.

#### 2.1.2.2 Agency

The traditional concept of agency addresses a relationship in which a party (named the *principal*) will draw up a contract with another party (named the *agent*) to act on its behalf (or can be a relationship implied from circumstances).<sup>112</sup> Consequently, the acts and contracts made by the agent will make liable and obligate the principal.<sup>113</sup>

Piercing the corporate veil on grounds of agency is not simple because it clashes with the structure of the corporation. The corporation is a person with rights and liabilities but it is an incorporeal being. Thus, this entity acts in society through its administrative organs which are formed by directors and staff authorised to act on its behalf. The corporation performs through an agency relationship. Moreover, the corporation is an instrument created to carry out commercial enterprises. This entity does that by having complete independence from its shareholders. Hence, to consider a company as an agent of the members would, indeed, defeat the concept of Joint Stock Corporation. The House of Lords, in the decision over the case of Salomon, emphasised this fact by stating that a corporation generally is not an agent of its members.<sup>114</sup>

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<sup>111</sup> See. *Idem*. At page 7

<sup>112</sup> See, Harris, J. **Lifting the Corporate Veil on the Basis of an Implied Agency: A Re-Evaluation of Smith Stone & Kingth.** *Company and Securities Law Journal*. (Volume 23) 2005 At page 4

<sup>113</sup> See, *ibid*. At page 4

<sup>114</sup> In the analysis of the Salomon case Lord Herschel comments “In a popular sense, a company may in

In the case *Smith, Stone and Knight Ltd v Birmingham Corporation*, Judge Atkinson in his decision relied on the concept of agency.<sup>115</sup> In this case, a company ran a subsidiary on land that was acquired by the local council. The parent company did not receive any compensation from the disturbance of the subsidiary's activities made by the council. The council denied compensation based on the fact that both companies were separate legal entities. The Judge considered piercing the corporate veil in order to allow the parent company to claim compensation for disturbance. Thus, in order to justify his decision, Judge Atkinson accepted an argument supported by agency. However, rather than traditional agency, he adapted the concept in accordance with the corporate structure and established a test in order to determine whether there was or was not an agency relationship between the parent company and the subsidiary. This test consisted of answering a set of questions regarding aspects of the parent company and subsidiary relationship, such as ownership, control and benefits.<sup>116</sup> Commentators have addressed this variation of traditional agency as implied agency. The concept of agency in this context is aimed at groups of companies and it has been based mainly on the degree of control that the parent company has over the subsidiary.<sup>117</sup> However, an exception based on control does not necessarily provide a strong case.

Throughout the years, corporate groups have gained more relevance and the elements regarding their structure have been the subject of study by commentators and judiciary. As a result, the dominance of the parent company over the subsidiary(s)

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every case be said to carry on trading for and on behalf of its shareholders. However, in the point of view of the law, this certainly does not constitute the relationship of principal and agent or render the shareholders liable to indemnify the company against the debts incurred." See, Lord Herschel comments in *Salomon v Salomon & Co.* [1897] A.C. 22. At page 43

<sup>115</sup> *Smith, Stone and Knight Ltd v Birmingham Corporation.* [1939] B.C.L.C. 480

<sup>116</sup> The Atkinson test consist is six questions, which are:

1. Were the profits treated as the profits of the parent company?
2. Were the individuals conducting the business appointed by the parent?
3. Was the parent company the head and the brain of the trading venture?
4. Did the parent company govern the venture and decide what should be done and what capital should be invested in the venture?
5. Did the parent make the profits by its skill and direction?
6. Was the parent company in effectual and constant control?

<sup>117</sup> The approach developed by judge Atkinson was originally intended to address a corporate group relationship. See, Harris, J. *Supra note* 112. At page 3

has been considered as a normal aspect of a corporate group.<sup>118</sup> This form of business organisation is based on a group of entities that agree to act under a common administration to achieve a common purpose. Consequently, a degree of control by the parent company over the subsidiary is necessary and it will vary in accordance with the type of enterprise.<sup>119</sup> In order to make a strong case in proving dominance over a subsidiary, the argument must therefore be accompanied by facts regarding the finances and governance of the subsidiary.

Currently, implied agency does not have the same reception as the sham exception.<sup>120</sup> A factor that may have influenced the current perception of implied agency in the corporate veil context is the origins of this exception. Indeed, this is an exception that derived from a case that did not involve a misuse of the corporate entity. Instead, the veil was pierced in favour of the incorporators, something that has not been well perceived by the judiciary in any jurisdiction.<sup>121</sup> Moreover, the test developed by Judge Atkinson was based mainly on the degree of control of a parent company over a subsidiary; as has been mentioned, the control of a parent company is an aspect that has been gradually accepted with the evolution of corporate groups. Therefore, whether a company is controlled to a higher or lesser degree is an argument that has weakened in deciding whether or not to pierce the corporate veil.

The sham exception as a means to deal with corporate personality issues has provided a more solid ground than the implied agency. This can be attributed to the fact that the sham exception focuses on the concurrence of fraud rather than control.

### 2.1.2.3 Single Economic Unit

In principle, a corporate group is not recognised as a new entity but rather each corporate member remains a separate entity with its own rights and liabilities.<sup>122</sup> The

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<sup>118</sup> See, Fuentes, C. *Supra note 70*. At page 5

<sup>119</sup> See, Bainbridge, S. **Abolishing veil Piercing**. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=236967](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236967) [last visit may 30, 2013] At page 71

<sup>120</sup> See, Hargovan, A. & Harris, J. **Piercing the Corporate Veil in Canada: A Comparative Analysis**. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=980366](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980366) [last visit may 30, 2013] At page 5

<sup>121</sup> See, Gaertner, M. *Supra note 56*. At page 668

<sup>122</sup> This principle is reaffirmed by the Court of Appeal in the case *The Albazero* ;“ each company is a group of companies... is a separate legal entity possessed of separate legal rights and liabilities so that the rights of a company in a group cannot be exercised by another company in that group even though

concept of a “single economic unit”, however, appears as an exception to this principle. Indeed, it is likely that courts show a degree of willingness to regard the corporate group as one economic unit based on the wording of a particular statute or contract (particularly for tax purposes).<sup>123</sup> An example is *Sepia Logistics Ltd (formerly known as Double Quick Supplyline Ltd) and another v Office of Fair Trading*,<sup>124</sup> where the Office of Fair Trading regards a group of companies as a single economic unit for purposes of an investigation for anti-competitive practices. However, the concept of a single economic unit as a doctrinal approach to deal with corporate veil issues has not been widely accepted.

A doctrinal approach to deal with corporate veil issues single economic unit made its debut in the case *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*.<sup>125</sup> DHN Food Distributors Ltd (DHN) was a holding company which ran its business through two wholly owned subsidiaries. One of the subsidiaries held the title of the land where the warehouse that DHN used to carry out its business was located. The Borough Council compulsorily acquired the land and refused to pay compensation for disturbance because DHN did not own the land and the subsidiary did not have an interest in the business. In other words, the veil of incorporation created a troublesome situation for the parent company. However, the Court of Appeal agreed to disregard the legal entity and consider the group of companies as a single economic unit in order for the parent company to receive the proper compensation for the disturbance of the business. The decision regarding this case was heavily influenced by the comments of Lord Denning, an English Judge who has been known for his tendency in favour of disregarding the legal entity.<sup>126</sup> Lord Denning on the DHN case argued that the subsidiaries were strongly influenced and subject to the will of the parent company. In the DHN group, there was only one business and two of the three companies forming part of the group did nothing but own the businesses’ fixed assets. Therefore, based on this fact, Lord Denning

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the ultimate benefit of the exercise of those rights would endure beneficially to the same person or corporate body irrespective of the person of body in whom those rights were vested.” See, Mayson, French and Ryan. *Supra note* 101. At page 145

<sup>123</sup> See, Farrar, J. **Farrar’s Company Law**. 4th Edition. London: Butherwords; 1998. At page 73

<sup>124</sup> *Sepia Logistics Ltd (formerly known as Double Quick Supplyline Ltd) and another v Office of Fair Trading* [2007] CAT 13, (Transcript)

<sup>125</sup> *DHN Distributors Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852

<sup>126</sup> See, Digman, A. & Lowry, J. *Supra note* 44 . At page 36

compared the relationship between the parent and the subsidiaries to that of a partnership in which all the partners participate in a business with a common view of profit. These grounds supported the argument that the group of companies was, in reality, a single economic entity and should be treated as one.

The Court of Appeal's decision in the DHN case was exceptional for that time.<sup>127</sup> Two years later, the case *Woolfson v. Strathclyde Regional Council* presented similar circumstances to those in the DHN case.<sup>128</sup> A company carried out its business on a property owned by another company and Mr. Woolfson held the majority of shares in both companies. The council compulsorily acquired the land but there was no compensation. Thus, Mr. Woolfson claimed for compensation through an argument supported by the precedent established in the DHN case. However, the court did not accept the single economic unit argument. The basis of this precedent was considered weak.<sup>129</sup> Consequently, the approach proposed in the DHN precedent lost relevance because of the arguments presented in the decision of Woolfson.<sup>130</sup>

As a doctrinal approach to hold shareholders liable (natural and legal persons), the single economic unit has not been widely applied. This was not properly elaborated on the DHN judgment and the argument to address the companies as a sole unit was not consistent. Moreover, the fact that this was a compensation case, I consider, affected the development of this approach. As above mentioned, the English judiciary may allow an exception to the corporate personality if this has been used as a sham for fraudulent purposes; for instance, the circumstances of the DHN case did not fall within the established ground on which to apply this remedy.

The English single economic unit shares the same origins as implied agency as both are based on cases in which the party seeking to pierce the corporate veil is the shareholder who created the veil and benefitted from it. I personally regard this fact as

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<sup>127</sup> See, Mayson, French and Ryan. *Supra note* 101. At page 145

<sup>128</sup> *Woolfson v. Strathclyde Regional Council* 1978 SC (HL) 90

<sup>129</sup> Lord Keith of Kinkel questioned the validity of the precedent in DHN and the single economic unit approach. He emphasised the exceptional nature of a remedy such as piercing the corporate veil by making reference to the principle previously established with the concept of sham, "... the veil will be upheld unless it was a façade." See, Lord Keith of Kinkel comments in *Woolfson v. Strathclyde Regional Council* 1978 SLT 159. At p 161

<sup>130</sup> See, Vandekerckhove, K. *Supra note* 74. At page 76

one of the main causes for the single economic unit's lack of success as a doctrine to address corporate entity issues. However, in spite of this, the single economic unit is still an available remedy to address the disregard of the legal entity in English company law.<sup>131</sup>

### 2.1.3 The case *Adam v Cape Industries*

The modern corporate personality has experienced changes since the decision in the case of *Salomon*. The specific facts of the *Salomon* case concerned a small private company established and run by an individual human trader. However, this circumstance gradually changed with the advent of corporate groups and multinational companies. Indeed, a network of subsidiaries created extra-layers of limited liability and encouraged ambitious enterprises. Moreover, subsidiaries established in different countries extended company law issues on an International scenario. The principle established in the case of *Salomon*, however, can be considered as one of the few aspects of English company law that has not changed throughout the years: “the corporate personality will not be disregarded unless this has been used for an unlawful purpose”.

The case *Adam v Cape Industries* is a contemporary case that has been the subject of interest among the common law judiciary and academia, due to the fact that this case involved different legal issues (conflict of law, tort and corporate personality issues in the context of corporate groups). However, for the purposes of this thesis I will focus on the corporate personality issue presented in the case of *Adam v Cape Industries* because in this case the different English approaches to deal with the corporate personality are reviewed.

In order to explain the influence of this case on the current English position with regard to the corporate personality, the facts of the case will be briefly addressed. It will then be explained how the English court regarded each of the arguments based on the existing methods to deal with the corporate veil.

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<sup>131</sup> See, *Adams v Cape Industries* [1990] B.C.C. 786

### 2.1.3.1 The Facts

Cape Industries (Cape) was a company created in England. It was the parent company of a group of companies and together they were dedicated to the extraction and marketing of asbestos.<sup>132</sup> During the Twentieth Century, Cape developed a profitable business. By 1953, Cape decided to expand its business to America. Thus, a subsidiary called “North American Asbestos Corporation” (NAAC) was created. It reported high profits during the late 1950s. Meanwhile, early reports of diseases produced by asbestos came to light.

By the 1970’s, NAAC and its parent company Cape Industries were sued by the victims of asbestos diseases. NAAC arranged a settlement with the victims and paid compensation. However, NAAC exhausted its insurance and to re-insure would have cost more than the business was worth. Therefore, Cape decided to liquidate NAAC as part of a process of reorganisation in order to continue the selling of asbestos on the American market. However, new cases against Cape soon materialised yet Cape Industries refused to appear in American courts. Cape’s defence was based on the corporate veil.

The responsibilities of operations previously executed by NAAC were transferred to a company called “Continental Products Corporation” (CPC). CPC was not a subsidiary of Cape. CPC had a relationship with Cape through a company created in Liechtenstein, “Associated Mineral Corporations” (AMC), whose stock was held by a Liechtenstein lawyer who was instructed by Cape. In other words, AMC was the “middle-man” in the relationship between Cape and CPC.

The plaintiff established proceedings against Cape and obtained a successful judgement in the U.S. courts. Therefore, this judgement was presented in English Courts to be enforced against Cape. The plaintiff argued that Cape had continued the asbestos business in the U.S. via CPC. Arguments to make Cape liable were

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<sup>132</sup> Asbestos is a type of fireproof industrial mineral, which has been catalogued as dangerous. The exposure to this mineral may cause a lung disease (asbestosis) and lung cancer. See, Tweedale, G. & Flynn, L. **Piercing the Corporate Veil: Caper industries and Multinational Corporate Liability for a Toxic Hazard, 1950-2004**. Published by Oxford University Press on behalf of the Business History Conference. 2007. Available at <http://es.oxfordjournals.org/content/8/2/268.short> [last visit may 30, 2013]. At page 272

developed on grounds of agency and single economic unit. Furthermore, it was argued that CPC and AMC were part of a sham for Cape to avoid liabilities. However, the English Court did not hold Cape liable because the court regarded that Cape had made a legitimate use of the corporate structure.

#### 2.1.3.2 The Corporate Veil Point (Sham Argument)

The arrangements made by Cape in regard of NAAC, AMC and CPC restructured the whole operation of Cape Industries in the U.S.. Cape industries decided to close its subsidiary (NAAC) in the U.S. to reduce its involvement in the marketing and sale of asbestos. However, it did not cease trading in the U.S.; rather Cape made an agency agreement with another company (CPC), which was a company incorporated in Liechtenstein that AMC managed. During the proceedings the Plaintiff sought to prove that this arrangement was made with the intention to constitute a façade for Cape to avoid liabilities towards asbestos victims. Through the sham argument the plaintiff wanted to trigger the piercing of the corporate veil in order to regard the CPC's presence in the United States as the presence of Cape.

The Court of Appeal concluded that AMC was not more than a corporate name, an entity controlled by Cape. Cape held the majority of shares and controlled its management. However, AMC was a company incorporated in Liechtenstein and did not practice any operation in the U.S.. Therefore, although it fell under the scope of sham, it did not help to determine the presence of Cape Industries in the U.S.. On the other hand, CPC was considered an independent legal entity that practiced its operations legally. Indeed, there was a connection between CPC and Cape through AMC. However, the Court of Appeal considered that the way Cape restructured its operations was legal.<sup>133</sup> The motives behind the modifications of the group structure were made in order to reduce (future) liability.<sup>134</sup>

The Court of Appeal starts its analysis about the corporate veil point citing the wording of the case *Woolfson v. Strathclyde Regional Council*, in which it is said that “it is appropriate to pierce the corporate veil only where special circumstances exist

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<sup>133</sup> *Supra note* 131. At page 823

<sup>134</sup> *Ibid*

indicating that it is a mere façade concealing the true facts”.<sup>135</sup> Throughout the analysis of the facts, the court found no special circumstance that could justify this remedy. The Court of Appeal held that “whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law”.<sup>136</sup>

### 2.1.3.3 Single Economic Unit

Cape, NAAC and CPC were separate legal entities. Certainly, Cape and NAAC had a relationship Parent-Subsidiary and for legal effects Cape was present in the U.S. through NAAC. The restructuring of Cape’s operations eliminates its subsidiary NAAC and to trade asbestos CPC was created. The claimant argued that although the companies are separate legal entities, there are special circumstances in which the distinction between companies is ignored and are regarded as one entity. He cited different precedents such as *DHN Food Distributor Ltd v London Borough of Tower Hamlets* and *Revlon Inc v Cripps & Lee Ltd*,<sup>137</sup> in order to support his argument. However the Court of Appeal rejected the argument based on single economic unit upon the basis of the fact that CPC was not a subsidiary of Cape; CPC had an agency contract with AMC, both different legal entities from Cape.<sup>138</sup>

On the one hand, NAAC was one of Cape’s subsidiaries and as such it was subject to Cape’s influence over finance and management. The plaintiff argued that Cape was involved in the day-to-day running of NAAC, a factor that undermines the independent existence of a subsidiary. However, the Court of Appeal considered that formalities regarding NAAC existence were respected, thus the distinction between Parent and Subsidiary cannot be bridged. On the other hand, regarding CPC, the single economic unit argument was rejected because CPC was not one of Cape’s Subsidiaries; it was a legal entity independent from Cape.<sup>139</sup>

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<sup>135</sup> *Idem.* At page 516

<sup>136</sup> *Idem.* At page 826

<sup>137</sup> This case involved an issue regarding the ownership of a trademark. For the purpose of determining Revlon Inc as beneficiary of the product, Suisse subsidiary and the parent were regarded as a unit. See, *Revlon Inc v Cripps & Lee Ltd [1980] FSR 85*

<sup>138</sup> *Supra note* 131. At page 823

<sup>139</sup> *Idem.* At page 515

#### 2.1.3.4 The Agency Argument

In this case, agency was one of the plaintiff's arguments to support an action to hold Cape Industries liable and pay compensation to victims affected by asbestos diseases. The plaintiff developed this argument against NAAC and CPC. As is previously mentioned, the former was Cape's subsidiary that was liquidated, whilst the latter was an independent company, which continued the operations of the liquidated company.

NAAC as a subsidiary of Cape had its own legal personality, assets and management.<sup>140</sup> The court found that, indeed, NAAC acted in some circumstances as an agent of Cape. NAAC assisted in the marketing of asbestos in the U.S., it arranged the performance of contracts between U.S. customers and the Cape group, and it had a co-ordinating role, (particularly in arranging delivery). However, NAAC did not have any authority to represent Cape and make it liable for any contract.<sup>141</sup> Thus, the court did not find enough justification to deal with Cape and NAAC as a single entity on grounds of agency.

Regarding CPC, the court considered CPC as a separate and independent entity. Certainly there was a connection created between Cape and CPC through AMC. However, Cape did not hold any shares nor had it any type of direct influence as it had over NAAC. CPC was an independent legal entity with its own business.

#### 2.1.4 Reception of Adams v Cape Decision

The decision over the case of Cape has produced different academic opinions. Some of them have been negative, mainly based on the fact that "it constituted an unconscionable denial of human liability for harm caused to other people and therefore the veil should have been lifted on an equitable basis".<sup>142</sup> The decision over Cape is also regarded as a precedent that accentuates the conservative position of English Courts in regard to the corporate entity.<sup>143</sup> Moreover, it has generated a

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<sup>140</sup> *Idem* At page 522

<sup>141</sup> *Ibid*

<sup>142</sup> See, Hudson, A. **Understanding Company Law**. Oxon: Routledge; 2012. At page 38

<sup>143</sup> See, Farrar, J. *Supra note* 123. At page 74

restrictive approach to corporate personality issues.<sup>144</sup> Indeed, it has considerably narrowed the possible rationale for piercing the corporate veil in England.<sup>145</sup>

Certainly, *Adams v Cape* is a precedent that evidences a degree of unfairness. However, opinions sharing the observations made by the court have also arisen. It has been appreciated that Cape took the necessary steps to “quarantine” the impact of such liability of its business activity.<sup>146</sup> In the case of Cape there was not any fraud or intention to harm the claimants. There was only a coherent use of the corporate personality advantages. Moreover, it has to be considered that the corporate personality has evolved and is not as simple as it was in the days of *Salomon*. Today, the reality is more complex as most large businesses are carried on through the medium of corporate groups of business.<sup>147</sup>

As a personal observation, I cannot deny the concurrence of unfairness. However, I agree with the Court’s position and the fact that Cape acted legally. I summarise my opinion on the case of Cape with fact that the corporate personality is a tool that when used, involves a degree of “collateral damage”.

### 2.1.5 The Piercing of the Corporate Veil after Cape

The case of Cape definitely refreshed the conservative positions of the English Courts with regard to the corporate veil. Prior to the case of Cape, the English courts did not pierce the corporate veil, which is a fact that has not changed in the “post-Cape” era. English courts have not omitted the option of piercing the corporate veil and have even gone as far as to accept that the veil can be pierced in exceptional circumstances. However, concrete grounds on which to pierce the corporate veil have not yet been developed.

The previously cited precedents of *Guilford Motors v Horne* and *Jones v Lipman* are popular English corporate veil cases in which the corporate personality was not

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<sup>144</sup>See, Digman, A. & Lowry, J. *Supra* note 44. At page 41

<sup>145</sup>See, Higgs & Goo’s. **Cases & Materials on Company Law**. 7th Edition. Oxford: Oxford University press; 2011. At page 121

<sup>146</sup>See, Davis, P. & Worthington, S. **Gower & Davis Principles of Modern Company Law**. 9th Edition. London: Sweet & Maxwell; 2008. At page 208, Paragraph 2-13

<sup>147</sup>See, Lowry, J. & Reisberg, A. **Pettet’s Company Law and Corporate Finance**. Essex: Pearson Education Limited; 2012. At page 47

ignored; rather liability was extended. It can certainly be considered that to avoid conflicts with the principle established in the case of *Salomon*, English courts have opted for a less direct approach. An example of this tendency in the period “post-Cape” can be found in the case, *Creasy v Breachwood Motors Ltd.*<sup>148</sup> In this case Mr. Creasy worked for Welwyn Motors Ltd (Welwyn) as the company’s manager. Welwyn conducted its business at premises owned by a company called Breachwood Motors Ltd. (Breachwood). Two individuals owned the shares and were the directors of both companies. It is important to add that both companies were not part of a group; therefore there was not a parent subsidiary relationship. Mr. Creasy was dismissed and he decided to start proceedings for wrongful dismissal. However, before proceedings could be brought to Welwyn, the company ceased trading. Breachwood took over all of Welwyn assets and paid off Welwyn’s creditors, with the exception of Mr. Creasy’s claim. Mr. Creasy applied to have Welwyn substituted by Breachwood as the defendant. Breachwood appealed based on the fact that both companies were separate legal entities. Consequently it could not be responsible for the compensation payable to Mr. Creasy, which was an obligation of Welwyn. However, the appeal was dismissed. In this case, Richard Southwell Q.C. opined that the power of the court to lift the corporate veil exists and should be exercised to achieve justice when necessary.<sup>149</sup> However rather than piercing the corporate veil and holding Welwyn shareholders liable, Breachwood became a defendant.

In the decision in *Creasy v Breachwood Motors Ltd*, the court considered the piercing of the corporate veil. However, this case did not involve a real disregard of the legal entity. In fact, the integrity of the corporate personality was respected. Certainly, the reasoning in this case pointed to piercing the corporate veil yet the influence of the *Salomon’s* precedent and the reaffirmation of this in the case of *Cape* made the court opt for a less direct approach, extending the proceedings to the other company. It is important to add that even though English courts tend to opt for a less direct approach to avoid conflicts with the corporate personality, the affected party does not always succeed. An example is the decision made in the case *Ord v Belhaven*

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<sup>148</sup> *Creasy v Breachwood Motors Ltd* [1992]BCC 639

<sup>149</sup> “The power of the court to lift the corporate veil exists. The problem for a judge of first instance is to decide whether the particular case before the court is one in which that power should be exercised recognising that this is a very strong power which can be exercised to achieve justice where its exercise is necessary for that purpose, but which misused would be likely to cause not inconsiderable injustice.” See, the opinion of Richard Southwell QC, *idem* at page 646

*Pubs Ltd*, in which the plaintiff requested to substitute the defendant company for its parent on grounds of the case *Creasy v Breachwood Motors Ltd*, but the Court of Appeal refused.<sup>150</sup>

A more recent example of the English court's manner in which they deal with corporate personality issues is the indirect means they used in the 2012 case *Chandler v Cape*.<sup>151</sup> In this case, the plaintiff worked for a subsidiary of Cape PLC during the late 1950s and early 1960s. The subsidiary was shut down and fifty years later the Plaintiff was diagnosed with asbestosis. The Plaintiff started proceedings against the parent company (Cape PLC) of the nonexistent subsidiary and the court had to deal with the dilemma regarding the liability of the parent company. The court omitted the piercing of the corporate veil because in principle parent companies are not liable for the negligence of the subsidiary. However, liability of Cape PLC was established on other grounds. The court regarded the knowledge that Cape PLC had over the harsh effects of asbestos as a determining factor. Moreover, the court stressed that Cape PLC was liable not because it assumed the liability of the subsidiary but because it owed a duty of care to Mr. Chandler.

In the “post-Cape” era, certainly, no inclination for an approach to pierce the corporate veil has been developed in English company law. However, the piercing of the corporate veil is still constantly debated and opinions about the application of this remedy are never-ending in English Courts. The recent decision in the 2013 case *Prest v Petrodel Resources Limited & others*,<sup>152</sup> presents a revision of the English cases on this subject. Although this case finished (as have previous cases) without the corporate veil having been pierced and with concurrence to the statement, “the veil

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<sup>150</sup> In the case *Ord v Belhaven Pubs Ltd*, the plaintiff took a 20 years lease of a public house from the defendant. The defendant was a subsidiary within a group of companies controlled by Ascot Holding PLC. The plaintiff alleged serious misrepresentations and breach of warranty and claimed damages in tort and contract. Prior to the trial the group was restructured and the defendant was left without any substantial assets. Therefore, the plaintiff applied to substitute the defendant company for the parent. The first instance court decided in favour of the plaintiff by considering the restructuring of the group in detriment of the plaintiff's claim unjust. However, the Court of Appeal reversed the first instance decision. Following the precedent established in *Adams v Cape Industries*, the court concluded that the defendant company could not be construed as a mere façade insofar as the transfer of B's assets was undertaken without any intention to harm the plaintiffs. The court held that the motive for the restructuring had been based upon an understandable business decision undertaken as a consequence of decline in the property market. See, case *Ord v Belhaven Pubs Ltd* [1998] BCLC 447

<sup>151</sup> *Chandler v Cape* [2012] EWCA Civ 525

<sup>152</sup> *Prest v Petrodel Resources Limited & others* [2012] EWCA Civ 1395

can only be pierced in limited circumstances”, this case is regarded a breakthrough since it presented a point which is discussed in the first chapter: the relevance of public policy.<sup>153</sup>

*Prest v Petrodel Resources Limited & others* was a divorce case in which the wife sought to enforce her rights over properties owned by a group of companies of which her ex-husband was the beneficial owner. The issue was whether the court had the power to transfer the properties of the companies to the wife. The question was solved under the Matrimonial Clauses Act 1973. It was emphasised that the act conferred wide powers to the judge to enforce ancillary relief; to ignore the corporate personality was considered as a faculty of the judge, based on the public interest contained in this Act.<sup>154</sup> However, in this case the veil was not directly pierced. Rather the companies were considered as merely trustees of the husband and consequently the companies were ordered to transfer the assets to the wife. The decision of the Family Court was supported on grounds of the beneficiary ownership of the husband over the companies. Certainly, the companies were properly incorporated and no irregularity existed but the objective of the court was to tackle the concealment tactic.<sup>155</sup> The relevance of this case lies in the fact that concealment tactics that involve the corporate personality have lost relevance in the context of family law.

Since the decision regarding Cape, the English Courts have continued the tendency to use alternative methods to deal with corporate personality issues. It can be considered that grounds on which an argument to pierce the corporate veil are likely to succeed are limited to cases involving circumstances that affect the interest of the state such as a corporate entity owned by citizens of an enemy state.<sup>156</sup>

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<sup>153</sup> See, **Chapter One**. At page 30-32

<sup>154</sup> See, *Supra note 152*. At page 6

<sup>155</sup> *Idem* at page 22-29

<sup>156</sup> The case *Daimler v Continental Tyre & Rubber Co* [1916] 2 AC 307 involved a company owned by an enemy state. In the case, Continental Tyre Co. sought to enforce a debt owed to them by Daimler. However, the membership of Continental Tyre Co. was comprised of German citizens, a country that at that moment was at war against England. Although Continental Tyre Co. was a UK registered company, the House of Lords refused to sanction the enforcement of the debt and refused to recognise that this company was an independent entity from its membership. This case is an example of a circumstance where the interest of the State is over the corporate personality and principles that support its existence.

### 2.1.6 The Disregard of the Legal Entity in the Context of English Statutory Law

The statutory provisions aimed at deterring certain misuses of the corporate entity do not represent a desire of the English judiciary to override the rule established in the precedent of *Salomon*. Instead, the statutory bodies in this context are aimed at extending the company's liability to those responsible for the misuse of the corporate personality in determined circumstances.<sup>157</sup> In other words, the corporation's separate personality is not ignored but instead it overrides the principle of limited liability. Certainly, the legal personality may be disregarded if the formalities for incorporation, established in the Company's Act, are not followed. However, when a company is incorporated, all the requirements tend to be followed in order to avoid any future inconvenience.<sup>158</sup>

The current statutory regulation for companies is the Company's Act 2006 which, when dealing with abuses of the corporate personality, is supplemented by the Insolvency Act 1986. Statutory law in this context has been developed as a protection for creditors against losses resulting from negligent and fraudulent management of companies. Indeed, statutory provisions in this context have been developed mainly in the area of Insolvency proceedings. Provisions regarding fraudulent and wrongful trading and abuse of the company's name will extend liability to managers when an anomaly is found during the winding up of the company.

These provisions are mainly aimed at directors, who are the ones dealing with the company's management on a daily basis.<sup>159</sup> Shareholders become subject to these rules when they participate or have a strong influence over the board of directors (shadow directors).<sup>160</sup> It is important to add that hired directors do not enjoy the

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<sup>157</sup> Revenue law, Landlord and Tenant Act 1954, Trading with the Enemy Act 1939 and the Insolvency Act 1986, are some of the statutory bodies in which the misuse of the corporate entity has been addressed. See, Sealy, L. **Sealy's Cases and Materials in Company law**. 9th Edition. Oxford: Oxford University Press; 2010. At page 55

<sup>158</sup> There are certain requirements that have lost relevance. An example is the company's membership, due to the recognition of "single man company" in the Company's Act 2006. Prior to the Company's Act 2006, a company was required to have a minimum number of members. In the section 24 of the Company's Act 1985 it was established that a person who is a member of a company that does not have the required membership would be held liable together with the company for its debts.

<sup>159</sup> See, Sealy, L. *Supra note* 157. At page 53

<sup>160</sup> The concept of shadow director is defined in the Company's Act 2006 section 251; " shadow director means a person in accordance with whose directions or instructions the directors of the

benefits of limited liability, as do shareholders.<sup>161</sup> However, directors cannot be directly sued for the faults of the company. Actions against the company must be addressed against the company; directors will become part of the proceedings when their fraudulent or negligent participation in the company's default has been proven.<sup>162</sup>

#### 2.1.6.1 Fraudulent and Wrongful Trading

The concepts of fraudulent and wrongful trading are aimed at controlling directors' behavior and its effects are triggered if an anomaly is found during the liquidation process.<sup>163</sup> Both concepts share a similar objective but have different grounds for their application.

The concept of fraudulent trading was first introduced in Section 275 of The Companies Act 1929.<sup>164</sup> The objective of this provision has been to enable the liquidator to seek a contribution to the company's insolvent state from directors whose actions prior to the insolvency proceedings had been fraudulent. The concept of fraudulent trading was expected to provide a basis which would make liable any person who engaged in conduct that would satisfy the definition of fraudulent trading.<sup>165</sup> However, during the 1980's the Cork Committee, which was responsible for reviewing the U.K. insolvency law, considered that the concept of fraudulent trading was inadequate to provide compensation in situations where the person involved was not dishonest but merely reckless or negligent.<sup>166</sup> Thus, in the reforms made to insolvency law, a new provision was introduced whereby civil liability would arise in a much broader context. This has been addressed as wrongful trading.

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company are accustomed to act." See, Mason, French and Ryan. *Supra note* 101. At page 439, paragraph 15.3.3

<sup>161</sup> See, Sealy L, *Supra note* 157. At page 53

<sup>162</sup> See, Davis, P. & Worthington, S. *Supra note* 146. At page 197, paragraph 8-3

<sup>163</sup> See, Dine J, *Supra note* 102. At page 188

<sup>164</sup> See, Mansor, H. **Solvency, Company Director's Duties and the Problem of Process and Enforcement- A Comparative Study**. The University of Waikato. 2011. Available at <http://researchcommons.waikato.ac.nz/handle/10289/5851> [last visit may 30, 2013] At page 225

<sup>165</sup> In the case *Re Patrick & Lyon Ltd* [1933] Ch 786 the judiciary defined that "fraud in the context of trading connotes actual dishonesty involving, according to the current notions of fair trading among commercial men, real moral blame." See, *Re Patrick & Lyon Ltd* [1933] Ch 786. At page 790

<sup>166</sup> See, Griffin, S. **Company Law Fundamental Principles**. 4th Edition. Essex: Pearson Education Limited; 2006. At page 341

## Fraudulent Trading

The provisions concerning fraudulent trading can be regarded as a protection for creditors against fraudulent practices. The directors are, indeed, entrusted with the management and running of the company. Consequently, they are exposed to situations that may motivate opportunistic behavior. Fraudulent trading is currently addressed as a criminal and civil offence.

The Companies' Act 2006, Section 993 addresses fraudulent trading as a criminal offence that, if the company has been used to achieve a fraudulent purpose, is punished with imprisonment. An example is the case *Regina v Terrence Freeman*.<sup>167</sup> In this case, the defendant was director of an English company and chief executive officer of a Swiss company, both of which were used to carry out a fraudulent scheme. This consisted of requesting money from investors and for this to be traded using trading platforms and also was promoted as a hedge fund. However, the defendant did not have access to the trading platforms he used to convince investors and the hedge fund was non-existent. The defendant gave false financial statements and did not disclose his criminal record to the investors. By undertaking fraudulent trading and other statutory offences, he was sentenced to seven years of imprisonment.

Fraudulent trading is addressed as a civil liability when, during the course of the company's winding up, it is found out that the business was conducted with an intention to defraud other parties. Different to the criminal offence, the civil offence arises in the context of insolvency proceedings. This issue is currently addressed in Section 213 of The Insolvency Act 1986, which also establishes the penalty for this fault. However, because it is a civil offence, there is no imprisonment; rather, liable parties are to make contributions to the company's assets if the company does not have sufficient assets to meet its liabilities.<sup>168</sup> An example is the case *Kevin Ashley*

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<sup>167</sup> *Regina v Terrence Freeman* [2011] EWCA Crim 2534

<sup>168</sup> Section 213 of the Act states

(1) If in the course of the winding up of a company it appears that any business of the company has been carried out with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying out of the business in the manner above-mentioned are to be liable to make such

*Goldfarb (liquidator of Overnight Limited) v Arthur James Higgins, Andreas Charalambous Andreou and Lofti Chareb.*<sup>169</sup> In this case, the liquidator is the company which purchased computer parts from Germany. The computer parts were sold at a low price and the only profit that could have been made was from the retention of the Value Added Tax. The company never operated a bank account as all the payments were received and made through an account operated by Mr. Higgins. The revenue authorities obtained a default judgment against the company in respect of the V.A.T due. However, the company's assets were not enough to recover the debt owed. Therefore, the liquidator applied to make the defendants contribute to the company's assets on grounds of the fraudulent trading provision in Section 213 of The Insolvency Act 1986.

In order to hold a director liable on grounds of Sections 993 or 213, fraudulent intention and behavior must be proved. However, the claimant must be aware that there are other regulations addressing fraud, which in turn may be more suitable to support his claim. In the case *Morphitis v Bernasconi & others*,<sup>170</sup> two former directors of a company in liquidation were accused on grounds of Section 213, of carrying on the business of the company with intent to defraud creditors and for other fraudulent purposes and that they were liable to make contribution to the assets of the company. However, although the business was found to be intending to defraud, only one creditor was shown to have been defrauded. Consequently, the court considered that one defrauded party does not fall under the scope of Section 213. The court held that a single defrauded person has to develop his/her argument based on the general law of fraud; if one person is defrauded in the course of the company's business, this does not mean the whole business was executed with intent to defraud.

### **Wrongful Trading**

Wrongful trading has been addressed in Section 214 of The Insolvency Act 1986. Based on this concept, a director or a shadow director will be liable and will have to make a contribution to the company's assets (if the court thinks proper) if the negligent management of the company leads to insolvency. Negligent management

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contributions (if any) to the company's assets as the court thinks proper.

<sup>169</sup> *Goldfarb v Higgins & Ors* [2010] EWHC 1587 (Ch)

<sup>170</sup> *Morphitis v Bernasconi* [2003] EWCA Civ 289

has been addressed as wrongful trading because there are cases in which managers keep the company's business afloat even after the accounts or other management information have clearly revealed that the company is in a chronic, loss-making position,<sup>171</sup> consequently causing losses to creditors. An example is the case (*liquidator of Idessa (UK) limited*) *Idessa UK Limited v John Morrison & Christopher Povey*.<sup>172</sup> The liquidator, among the other claims, considered that the directors should be liable because they had knowledge of the company being on the border of insolvency and they did not take the necessary measures. The court observed facts such as the lack of regular meetings of the board to discuss the financial position of the company, the loss of income from external investors and the expense of financial resources. Based on the lack of measures to prevent the insolvency of the company, the court imposed liability on the directors on grounds of wrongful trading.<sup>173</sup>

In order to support an argument under Section 214 concerning wrongful trading, two elements must be proved:

- Knowledge, actual or constructive, that insolvent liquidation was unavoidable
- Failure to take every step to minimise potential loss to creditors

The first point is not aimed at creating pressure on managers. In the case *Earp & another v Stevenson & another*, the Court did say, “directors are not required to be clairvoyant.”<sup>174</sup> However, it is considered that a competent director must be aware of the company's finances.<sup>175</sup> Moreover, in a situation of financial difficulties a certain standard of thinking and behavior are expected in order to save the company or at least minimise the loss.<sup>176</sup> Indeed, as long as directors are proven to take measures such as spending cuts and consultations with professional advisors in order to handle the company's financial difficulties, they may be free from liability.<sup>177</sup>

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<sup>171</sup> See, Davis, P. & Worthington, S. *Supra note* 146. At page 222, at paragraph 9-11

<sup>172</sup> (*liquidator of Idessa (UK) limited*) *Idessa UK Limited v John Morrison & Christopher Povey* [2011] EWHC 804 (Ch).

<sup>173</sup> *Idem*. At paragraph 121

<sup>174</sup> *Earp & another v Stevenson & another* [2011] EWHC 1436 (Ch) (transcript) At page 13

<sup>175</sup> *Ibid*

<sup>176</sup> See, Davis, P. & Worthington, S, *Supra note* 146. At page 219 paragraph 9-8

<sup>177</sup> *Ibid*

A logical course of action would be to recognise the difficulties of the company and go into voluntary insolvency proceedings. However, although this may mitigate losses to creditors, it is not a guarantee that directors will be free from liability. Certainly, during the winding up of the company some evidence of reckless or negligent management that would put a director within the scope of Section 214 may be found. Such an example is the case *Re Farmizer Products Ltd.*<sup>178</sup> In this case, a company went into administration but it was unsuccessful and consequently it was placed in voluntary insolvency proceedings. Liquidators claimed that the directors should be liable and contribute to the payment of the company's debts on grounds of Section 214. They claimed that the directors were aware of the situation of the company before it went into administration but they continued trading. However, the court did not hold the defendants liable.

#### 2.1.6.2 Abuse of Company Name (Phoenix Companies)

The abuse of the company's name, known also as "Phoenix Company", is a situation that results from "the continuance of a failed company by those responsible for that failure, using the vehicle of a new company."<sup>179</sup> This new company trades under the same or similar name, has the same assets as before (acquired for a low price) and exploits its goodwill and business opportunities.<sup>180</sup> Meanwhile, the creditors of the previous insolvent company are left to prove their debts against a valueless shell and the management conceal their earlier failure from the public."<sup>181</sup>

The action of creating a new company that bears the same name and carries the same business may not, in principle, be improper. The lack of success of a company may be for reasons beyond the control of its directors. Moreover, the use of the same assets and trading style of the original company may be the only possibility for the employees to earn their livelihood. An example of this is the case *Lightning Electrical Contractors Ltd, Re*, in which the use of a previous company's name in order to

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<sup>178</sup> *Re Farmizer products Ltd* [1995] 2 BCLC 462

<sup>179</sup> See, Davis, P. & Worthington, S. *Supra note* 146. At page 224 & 225- paragraph 9-12

<sup>180</sup> *Ibid*

<sup>181</sup> *Ibid*

maximise the value of the first company's assets is allowed.<sup>182</sup>

However, the issue arises when the intention of setting a phoenix company is to defraud creditors. The English legislature has addressed this phenomenon through The Insolvency Act 1986. In Section 216, the use of the name (or a similar name) by which a company in process of liquidation was known (at least 12 months before the liquidation), is prohibited. Moreover, the directors of the company to whom this restriction applies cannot, for a period of five years thereafter, be director or manager of a company that bears a prohibited name, unless the court so allows. The Insolvency Act sanctions this misconduct in Section 217 through the extension of liability to the directors or shadow directors involved in the abuse of the company's name.

The case of *Ricketts V Ad Valorem Factors Ltd*, is an example in which the English judiciary addresses the issue of the prohibited name and director's liability.<sup>183</sup> Mr. Rickett was the director of the company, Air Component Limited, which went into liquidation. At the time of the company's liquidation, Mr. Rickett was also director of another company called Air Equipment Limited, which went into liquidation months later. The creditors of the latter claimed that Mr. Rickett should be personally liable for the company's debts on grounds of the prohibited name provision. In the first instance, the court held Mr. Rickett liable together with the company for its debts. Therefore, Mr. Rickett decided to appeal. The Court of Appeal engaged in studying whether Mr. Rickett should be considered as liable on grounds of the prohibited name provision. The names of both companies, as well as the assets that formed the assets of each one, were evaluated in order to determine the association between them and Mr. Rickett. The outcome was that Mr. Rickett's appeal was dismissed on grounds of section 216 (2-(b)), which established that similarities of names between the company in liquidation and another company suggested the existence of a relationship between the companies and the manager.<sup>184</sup>

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<sup>182</sup> The case *Lightning Electrical Contractors Ltd, Re* [1996] 2 B.C.L.C. 302 is cited and commented by Davis, P. & Worthington, S. *Idem*. At page 225, cite 63

<sup>183</sup> *Ricketts V Ad Valorem Factors Ltd* [2003] EWCA Civ 1706

<sup>184</sup> "It is a name which is similar to the name by which the liquidating company was known and so purposefully suggests an association with that company." *Idem*. At page 6

The prohibition in Sections 216 and 217 is not absolute. Certainly, this has its exception under the Insolvency Rules 1986. As mentioned in the first paragraph, there are some circumstances in which to trade under the prohibited name may be beneficial. However, the legislature has established some requirements in order to allow the use of a prohibited name. In the Insolvency Rules 1986 r. 4.230 it has been established that the use of the forbidden name will be allowed if the new company has been using the name for at least twelve months and the company has not been dormant.<sup>185</sup> An example of this is the case *ESS Production Ltd v Sully*.<sup>186</sup> In that case, Mr. Sully was the principal shareholder of an informal group of companies that used the acronym ESS in their name or trading name. One of the companies went into liquidation. Thus, a solvent company, which was part of the group, bought the assets. The solvent company traded under a name similar to the prohibited name, but creditors knew about it; in fact, the name of the group was well known. Furthermore, it was also a known fact that Mr. Sully played an influential role in both companies'. The Court in the first instance held Mr. Sully liable on grounds of Section 217(1). However, the defendant appealed, arguing that it complied with the exception to the restrictions over the name established in the Insolvency Rules r. 4.230. The Court of Appeal allowed the appeal of Mr. Sully based on the grounds of the Insolvency Rules 1986,

Indeed, the exception to the prohibited name rule exists. However, it is not always possible to be subject to this exception. In the case *First Independent Factors and Finance Ltd v Churchill and another*;<sup>187</sup> two brothers were directors of a company that went into liquidation. They created a new company with a similar name, which bought the old company's goodwill. The defendants claimed that they knew it was a forbidden name. Therefore, they realised the sale of the business to the new business based on the Insolvency Rules 1986, r 4.228.<sup>188</sup> Subject to this, providing they gave

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<sup>185</sup> r.4.230 third excepted case: The court's leave under Section 216(3) is not required where the company referred to, though known by a prohibited name within the meaning of the section:

(a) has been known by that name for the whole of the period of 12 months ending with the day before the liquidating company went into liquidation and

(b) has not at any time in those 12 months been dormant within the meaning of Section 252(5) of the Companies Act."

<sup>186</sup> *ESS Production Ltd v Sully* [2005] EWCA Civ 554

<sup>187</sup> *First Independent Factors and Finance Ltd v Churchill and another* [2006] EWCA Civ 1623, (Transcript: Wordwave International Ltd (A Merrill Communications Company))

<sup>188</sup> **Insolvency Rules 1986**, r 4.228"(1) Where a company ('the successor company') acquires the whole, or substantially the whole, of the business of an insolvent company, under arrangements made

notice to the previous creditors, they are not personally liable for the company's debts. However, the claimant denies receiving any such notice. Furthermore, the Court of Appeal considered that even if notice were given as claimed, such notice would not have been effective in relieving the Appellants from liability under Section 217(1). This is because it was a liability which had already arisen by reason of their having acted as directors of the new company *prior to* the giving of the alleged notice.

The provisions against phoenix companies are a product of the need for protection of good faith creditors. However, these rules do not involve piercing of the corporate veil. Instead, these provisions deal with directors and shadow directors who manipulate the corporate entity's assets.

#### 2.1.6.3 Tax Law and the English Corporate Entity

If there is a conflict between tax law and the corporate entity, it is likely that tax law will prevail.<sup>189</sup> Indeed, my perception of public law as a force stronger than the corporate fiction is evidenced in this area of English law. Certainly, I cannot say that English Courts act without considering the circumstances of the case. In England there is a tendency to protect the corporate entity. Consequently a conflict, which is more evident in cases involving corporate groups, exists.<sup>190</sup> I consider that the corporate entity has the opportunity to battle against the tax law enforcement in view of the fact that tax provisions are not aimed specifically at the corporate entity; rather these provisions seek to prevent and punish tax evasion. Nonetheless, in this conflict tax law tends to prevail.

An early case that exemplifies the controversy between revenue authorities and corporate groups is *Bartholomay Brewing Company v. Wyatt (surveyor of taxes)*.<sup>191</sup> In this case, an English corporation had been formed for the purpose of amalgamating three American breweries and carrying on the business under one management. The English company, however, faced a local restriction for foreign ownership of real property. Therefore, an American company was created in order to manage the

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by an insolvency practitioner acting as its liquidator, administrator or administrative receiver, or as supervisor of a voluntary arrangement under Part 1 of the Act, the successor company may, for the purposes of Section 216, give notice under this Rule to the insolvent company's creditors,

<sup>189</sup> See, Vandekerchhove, K. *Supra note 74*. At page 484

<sup>190</sup> See, Digman, A. & Lowry, J. *Supra note 44*. At page 32, at paragraph 3.3

<sup>191</sup> *Bartholomay Brewing Company v. Wyatt (surveyor of taxes)*. [1890-98] 3 T.C. 224

breweries. The English company held the majority of shares in the American subsidiary, but all the commercial operations were carried out in America and managed by the subsidiary. The issue in this case was in determining whether or not the English corporation was carrying on business wholly or partly in England.<sup>192</sup> If so, it would have been taxable for the whole of the profits made (whether remitted to England or not). If not, only the remitted profits would have been taxable. In this case, the court determined that in principle, shareholders do not manage the company. As an entity independent from its shareholders, a company carries out its own business through its directors and agents. However, although the English company was a shareholder and all the operations and management were carried out in America, the English company was considered to have had a high degree of control over the business decisions. Therefore, on this ground the profits became the subject of taxation.

The cited case took place in the early days of the modern joint stock corporation. Consequently, issues such as place of incorporation and place of business were the subject of analysis in the early days of corporate taxation. However, although corporate taxation has improved and concepts such as a company's residence have been clarified,<sup>193</sup> it has not completely resolved the problem because the use of the corporate group for tax evasion is still a current issue.

Modern tax provisions are aimed at the company's management rather than the corporate entity. As the concept of corporate personality has developed, it has also developed the concept of corporate taxation. Certainly, the structure of the corporate group is complex in that it allows the development of schemes to evade taxes.

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<sup>192</sup> The issue in this case derived from the fact that in the United Kingdom, income tax was invented before the registered company. In its early days, corporate entity taxation was regulated through the Income Tax legislation. However, tax law was originally aimed at natural persons, who were subject to taxation as long as they were residents in the UK. As a consequence, this regulation was not suitable for addressing the corporate entity. Indeed, the corporate entity was a new concept and there was no test to determine the residency of a company. Thus, the authorities filled this gap through the "central management and control" test. Through this test, a company's place of residence is determined by identifying the place of management, which was considered the place where the original business was carried out. See, Mason, French and Ryan. *Supra note* 101. At page 647; See, Flannigan, R. **Corporations Controlled by Shareholders: Principals, Agents or Servants.** *Sask Law Review.* (Volume 51) 1986 At page 71

<sup>193</sup> Currently corporate taxation can be regarded as more efficient. An example is the definition of a company's residence: "any corporate body, which is resident in the United Kingdom is subject to corporation tax on its income and chargeable gains, and is not subject to income tax or capital gains tax". See, Income and Corporation Taxes Act 1988, ss6 and 832(1)

However, instead of engaging in the “herculean task” of dealing with a group structure, authorities have focused on the management. Managers are the means by which the corporation acts in the real world. Consequently, most of the actions of the company can be attributed to the managers. A recent example is the case *Re Instant Access Properties Ltd; Secretary of State for Business, Innovation and Skills v Gifford and others*.<sup>194</sup> In this case, amongst the charges against the directors was the issue of tax evasion. It was alleged that the defendants, by creating a sham arrangement, which consisted of diverting income to a company incorporated in British Virgin Islands, had caused or allowed the company to structure its affairs in such a way that the UK tax authority, HMRC, received less money than was properly due.

Certainly, managers tend to be the objective of tax regulation rather than the corporate entity. However, for purposes of the judicial proceedings involving tax evasion, disregard of the legal entity is likely. An example is the case *Re H and others (Restraint Order: Realisable Property)*.<sup>195</sup> In this case, the defendants were the shareholder owners of two family companies used to evade tax duties on a large scale. They were placed under arrest and the corporate personality was disregarded. As a result, the stock in the companies' warehouses and the companies' motor vehicles were treated as available property held by the defendants.

Certainly, in a tax evasion scheme, managers may not be the brains behind the conduct. However, by establishing measures against managers they become aware of the effects of their (direct and indirect) involvement in a tax evasion scheme. Thus, this can, to some degree, deter the use of the corporate entity for tax evasion.

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<sup>194</sup> *Re Instant Access Properties Ltd; Secretary of State for Business, Innovation and Skills v Gifford and others* [2011] EWHC 3022 (Ch)

<sup>195</sup> *Re H and others (restraint order: realisable property)* [1996] 2 BCLC 500

## Summary

The case of *Salomon* established the basis for the current position of English courts with regard to the corporate personality: the corporate personality will be preserved as long as it has not been used for fraudulent purposes. However, no clear concept of fraud in this context was established. Years after the precedent in the case of *Salomon* the judiciary attempted to introduce exceptions based on the concepts of sham, agency or single economic unit. However, the cases in which these concepts were used did not involve the piercing of the corporate veil. Rather, alternative means were used to deal with the corporate personality. Consequently, the English authorities can be considered to have dealt with corporate veil issues in a way in which the integrity of the corporate personality is not affected. Moreover, in the case *Adam v Cape Industries* the English authorities reaffirmed the tendency to preserve the integrity of the corporate personality.

Currently, the piercing of the corporate veil is not a common practice in this jurisdiction. There is no systematic approach to apply this remedy. The grounds on which an argument to pierce the corporate veil is likely to succeed are limited to cases or circumstances that affect the interest of the state. In the context of positive law, rules contained in The Company's Act 2006 and The Insolvency Act 1986 are not aimed at affecting the integrity of the corporate personality. Rather, these rules are aimed at companies' directors and shareholders who have an active role in the management of the company. These statutes are a means to deter and punish the negligent and fraudulent management of the corporate personality. In the context of tax law, there is no direct exception to the corporate personality, but this is likely to be disregarded in this context due to the strong public interest that exists in favour of tax law.

## 2.2 The Doctrine of Piercing the Corporate Veil in the U.S.

The United States is the jurisdiction that can be considered as precursor of the doctrine of piercing the corporate veil. Certainly, the fact that the joint stock corporation has been in common use since the early days of the U.S. has also made corporate entity issues common in this jurisdiction. The American author, Maurice Wormzer, can be considered a pioneer in the study of this subject. Indeed, he analysed various situations in which the corporate entity should be ignored. Wormzer generalised that “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 of entity, will regard the corporate company as an association of live, up-and-doing, men and women shareholders, and will do justice between real persons”.<sup>196</sup>

The analysis made by Wormzer provides the rationale on which the piercing of the corporate veil has been applied in the U.S. Courts, which is to prevent and punish the improper use of the corporate entity. However, the formulation of a standardised approach to deal with corporate veil issues has not been an easy task. Company law in the U.S. is a matter left for each state to regulate; therefore, each state has its own notion about piercing the corporate veil, which tends to vary from state to state.<sup>197</sup> The uncontrolled piercing of the corporate veil may affect the economic benefits produced by the corporate entity and obstruct the development policies of each state. Consequently, each state has had a strong interest in applying its own laws in the area of piercing the corporate veil.

Nonetheless, in spite of the circumstances the U.S. authorities have managed to create an approach to deal with corporate personality issues. This approach consists of evaluating aspects regarding the degree of control of the shareholders over the

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<sup>196</sup> See, Wormser, M. **The Disregard of the Corporate Fiction and Allied Corporation Problems**. At page 40; Cited by Rudorfer, M. **Piercing the Corporate Veil, A sound Concept**. New York: New York University. 2006. At page 3

<sup>197</sup> See, Hartman, P. **Piercing the Corporate Veil in Federal Courts: Is Circumvention of an Statute Enough**. *Pacific Law Journal*. (Volume 13) 1982. At page 1246

company, the concurrence of fraudulent behavior and the existence of a link between the misuse of the corporate entity and the plaintiff's loss or harm. These factors have been arranged under the heading of the doctrine of instrumentality and alter ego. However, before addressing instrumentality and alter ego, the effects of state and federal law over piercing the corporate veil will be explained.

### 2.2.1 State and Federal Law

Each state has evaluated the factors that trigger the piercing of the corporate veil in accord to their own internal policy. Consequently, a situation exists where some states tend to be more willing than others to apply the piercing of the corporate veil. The different tendencies among the states are demonstrated by Professor Robert Thompson in an empirical study he made about piercing the corporate veil in the U.S.<sup>198</sup> Examples of the different tendencies are the States of Delaware and New York and, by the time Thompson made his study, the State of New York had produced more piercing cases than the State of Delaware.<sup>199</sup> On the one hand, the State of Delaware is known as a corporate-friendly jurisdiction and consequently reluctant to pierce the corporate veil. The position of Delaware authorities regarding the application of this remedy can be attributed to a policy aimed at protecting Delaware Corporations. On the other hand, the State of New York has been more open to consider piercing the corporate veil. New York is an important centre of commerce and, as in the State of Delaware, the corporate personality plays an important role. However, New York authorities have been critical of the concept of corporate personality. This can be attributed to a factor such as the influence of Judge Benjamin Cardozo, who questions the metaphor of the corporate personality in the case *Berkey v Third Ave. Ry. Co.*<sup>200</sup> Although, the veil was not pierced in this case, the comments

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<sup>198</sup> The study made by Professor Thompson was published in 1991. Although it has been more than twenty years since its publication, Thompson's study is still a relevant reference for the study of piercing the corporate veil in the U.S., because it was the first extensive empirical study in this area. See, Thompson, R. *Supra* note 51.

<sup>199</sup> By the time Thompson made his study, he found that the court did not pierce the corporate veil in any of the eleven reported cases decided under Delaware law. The position of Delaware courts on this subject has not changed since Thompson's study. In a relatively recent study made by the authors, Mcpherson & Raja, Delaware courts are still reluctant to pierce the corporate veil. See, *Idem* At p 1052. See also, Mcpherson, R. & Raja, N. **Corporate Justice**. *Wake Forest law Review*.(Volume 45) 2010 At page 949

<sup>200</sup> *Berkey v Third Ave. Ry. Co* 244 N.Y. 602 (1927)

of Judge Cardozo is one of the facts that has shaped New York judges' opinion about whether or not to pierce the corporate veil.

In a corporate veil case involving law from different states', the tendency is to apply the law from the state where the company is incorporated or the law chosen by the parties.<sup>201</sup> However, circumstances tend to differ when piercing the corporate veil involves a federal policy. Federal policies are products of a need for special regulation regarding the protection of a public interest, which may not be introduced in state company law because it would drive companies out of the state to more hospitable jurisdictions. States in the U.S. compete to provide a friendly environment for incorporation.<sup>202</sup> Consequently, aspects such as protection of investors, creditors, customers, employees and any circumstance involving a public interest have come from federal legislation.<sup>203</sup>

Federal courts have developed their own approach to deal with corporate veil issues, which has been based on the similar elements considered by the state courts; control over the company and the concurrence of fraudulent conduct.<sup>204</sup> However, federal courts have also included a third point that differentiates the federal approach from the state approach. This third point, regarded by federal courts, is based on the use of the corporation to circumvent a statute or frustrate legislative purpose.<sup>205</sup>

The First Chapter of this thesis addressed one of the premises followed in this work, which is based on the non-existence of a real piercing of the corporate veil in the cases where a public interest is in jeopardy.<sup>206</sup> This statement is supported by the prevalence of the public interest over the corporate personality. The fact that the U.S. federal courts have developed an approach to deal with corporate veil issues at federal level does not challenge the statement previously mentioned. The existence of a method to address corporate veil issues at federal level can be considered as a means

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<sup>201</sup> See, Gevurtz, F. **Piercing, Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil.** available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=140280](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=140280) [last visit may 30, 2013] At page 903

<sup>202</sup> See, Cary, W. **Federalism and Corporate Law: Reflections Upon Delaware.** *The Yale Law Journal.*(Volume 83) 1973. At page 665

<sup>203</sup> *Idem.* At page 668

<sup>204</sup> See, Hartman, P. *Supra note* 197. At page 1254

<sup>205</sup> *Ibid*

<sup>206</sup> See, **Chapter One.** At page 30-32

to emphasise the fact that, in order to pierce the corporate veil, this must have been used in a way which affects a public policy.

It is important to point out that the existence of state and federal jurisdictions may produce a conflict of law. This may arise when federal courts have to decide whether to apply federal law or state law. Federal courts have to determine whether federal law is more suitable than state law to deal with a corporate veil issue. The dilemma between both federal and state law in this context derives from the question; which may better serve the interest of public policies?<sup>207</sup>

Indeed, the U.S. courts and academia have questioned the extent to which a state policy regarding the preservation of the corporate veil may frustrate federal regulatory policy. An example of this controversy arises in the case *United States v Bestfoods*.<sup>208</sup> In this case, proceedings were taken against a company due to the pollution caused by its activities. This company was part of a group of companies and the claimants wanted to hold the parent company liable for the damages caused by the subsidiary. However, the Sixth Circuit Court absolved the parent company based on the fact that the parent company could only be held liable if the parent had sole or joint venture operation of the polluting facility. The Sixth Circuit Court applied law from the State of Michigan.<sup>209</sup> Thus, its decision followed notions of separate corporate personality contained in state law. However, the Supreme Court overturned this decision and held the parent company liable by considering the influence of the parent company over the subsidiary on grounds of the concept of operator contained in the “Comprehensive

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<sup>207</sup> The author Patricia J. Hartman, engages on the discussion about the role of federal law and state law in cases involving the piercing of the corporate veil. In her article, she establishes a set of factors established on case law and used by federal courts to determine whether to apply federal or state law. These factors include the extent to which:

1. A federal rule would disrupt commercial relationships predicated on state law.
2. Application of state law would frustrate specific objectives of the federal programme.
3. Implementation of a particular rule would cause administrative hardship or would aid in administrative conveniences.
4. The regulation could lend weight to the application of a uniform rule.
5. The action in question has a direct effect on financial obligations of the United States.
6. Substantial interest in the outcome of the litigation exists.

See, Hartman, *Supra note* 197. At page 1249- 1250

<sup>208</sup> *United States v Bestfoods* 524 U.S. 51 (1998)

<sup>209</sup> *United States V Cordova Chem Co. of Michigan*, 113 F.3d 572, 582 (1997)

Environmental Response, Compensation and Liability Act” (CERCLA).<sup>210</sup> The rationale behind the CERCLA Act has been based on the protection and preservation of public health and the environment, which can be considered as a public policy that overrides the concept of corporate personality. (The role of CERCLA in the context of corporate personality issues will be discussed in more detail later in this section)

The plurality of state corporate law, the tendency of each state to create a friendly environment for business and the use of federal law to deal with aspects regarding public interest, have definitely influenced, American doctrine of piercing the corporate veil.

### 2.2.2 The Doctrines of Instrumentality and Alter-Ego

The concepts of instrumentality and alter ego are names given to the set of factors that must concur to consider whether or not to ignore the corporate veil. These concepts have developed as different doctrines; the instrumentality doctrine was created to deal with corporate groups and the alter ego doctrine is principally applied in cases where the corporate entity is made up of one or two shareholders.<sup>211</sup> However, although both doctrinal approaches aim at a different objective, these are in essence the same. Both require the concurrence of the same factors in order to evaluate whether or not to ignore the corporate personality: control, fraud and causation.

**(1) Excessive control/lack of separate existence:** This factor consists of the excessive dominance that a shareholder(s) has over the corporate entity, to the point that the separate personality of the corporation and the individual no longer exists. Excessive control will be determined through the assessment of the relationship between the corporation and the shareholder. In this assessment aspects will be observed, aspects such as the influence of the shareholder over the company by the time the plaintiff dealt with the

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<sup>210</sup> The concept of operator makes reference to the ownership over the polluting facility. The grounds for the application of this concept in this context will be addressed later in the section regarding piercing of the corporate veil in the U.S. statutory law.

<sup>211</sup> See, Rudorfer, M. *Supra note* 196. At page 4 to 6

corporation and whether corporate formalities have been followed.<sup>212</sup> The influence of the shareholder is determined in the company's independent decision-making authority.<sup>213</sup> If the corporation has no power to take its decisions, it is likely to be regarded as controlled. With regard to corporate formalities, it has been considered that if a shareholder has not followed the minimum requirements established by law, they should not enjoy the benefits of legal personality and limited liability.

**(2) Fraud and inequitable conduct:** This factor consists in the concurrence of fraudulent or illegal behavior on the part of the shareholder controllers of the corporation. The concurrence of actual fraud or the intention to defraud or the existence of bad faith makes piercing the corporate veil likely. The rationale on this point is based on the fact that if the acts are treated as those of the corporation alone, an inequitable result will follow.<sup>214</sup>

**(3) Causation:** This factor consists in proving that the misuse of the corporate entity actually caused the claimant's loss.<sup>215</sup> In this thesis, a connection between the uses of the corporate veil for a fraudulent purpose and the loss suffered by the plaintiff as an essential requirement to determine whether or not to pierce the corporate veil is considered. If the piercing of the corporate veil is applied to cases where the corporate entity is not the cause of the loss or harm, this will produce the uncontrolled application of this remedy. As a result, the corporate entity will be undermined.

The courts normally require the concurrence of excessive control over the company and fraud derived thereby, in order to pierce the corporate veil. Causation, on the other hand, is not a requirement in some state courts.<sup>216</sup> In fact, there are some cases in which the veil has been pierced based on a circumstance that has no relation to the harm or loss of the plaintiff. An example is the case *Sea-Land Services v*

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<sup>212</sup> See, Olthoff, M. **Beyond the Form-Should the Corporate Veil be Pierced?** *UMKC Law Review*. (Volume 64) 1995. At page 313 to 316

<sup>213</sup> *Ibid*

<sup>214</sup> *Idem*. At page 316-318

<sup>215</sup> *Idem*. At page 318- 319

<sup>216</sup> See, Rudofe, M. *Supra note* 196. At page 9-10

*Pepper Source*.<sup>217</sup> In this case Sea-Land Services (plaintiff) shipped sweet peppers on behalf of “Pepper Source” (defendant). Pepper Source defaulted on the bill. Sea-Land filed a claim against Pepper Source but it was unable to collect because Pepper Source had no assets. Therefore, the plaintiff sought to pierce the corporate veil in order to hold the sole shareholder, Gerald Marchese, and other corporations he controlled personally liable. The court regarded the facts in the light of the precedent *Van Dorn Co. v Future Chem. & Oil Corp.*;<sup>218</sup> which can be considered a case in which emphasis was laid on the alter ego approach (explained later). First, with regard to excessive control/lack of separate existence, Marchese was the sole shareholder of the corporation and failed to maintain adequate records of the corporate formalities. Marchese and Pepper Source had the same office and the same expense accounts. Moreover, Pepper Source was not adequately financed for the risks of its business. However, the claimant could not prove the second required circumstance of the alter ego approach which consisted in proving that the allowance of limited liability would sanction a fraud or promote injustice. Despite the lack of consistent proof to support the second requirement, the Court decided in favour of the plaintiff in the first instance and held the defendant liable. However, the sentence was remanded because of lack of evidence to support the second requirement. Therefore, an argument supporting the fact that the company was also used to commit tax fraud was presented and the authorities, based on this argument, allowed the disregard of the legal entity.

The decision on *Sea-Land Services v Pepper Source* can be regarded as against the integrity of the corporate entity. Certainly, Pepper Source did not comply with its obligation and evidently was heavily controlled by Marchese. However, the fraudulent conduct of the defendant must be proved in circumstances related to the case. Tax fraud was far away from affecting the claimant and the fact that the court supported its decision on this factor is one of the reasons for the American doctrine of piercing the corporate veil to be the subject of criticism. Following, I will address the doctrines of instrumentality and alter ego in order to explain its differences and current role in U.S. corporate law.

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<sup>217</sup> *Sea-Land Services v Pepper Source* 941 F.2d 519 (CA7, 1991)

<sup>218</sup> *Van Dorn Co. v Future Chem. & Oil Corp.*, 753 F.2d 565, 569-70 (7<sup>th</sup> Cir. 1985)

### 2.2.2.1 The Alter-Ego Doctrine

The piercing of the corporate veil on grounds of alter ego is usually employed in circumstances where the claimant wants to prove that the shareholder(s) have failed to separate his/their affairs from those of the corporation. This approach is likely to be applied when the corporation is made up of one or two shareholders.<sup>219</sup> If the court, based on the proof and circumstances of the case, consider that the separateness of the corporation has ceased, the corporation will be considered as an alter ego of the shareholders. The rationale on which the alter ego doctrine has been founded can be considered as of a punitive nature; if the shareholders themselves ignore the corporate fiction, the court will do so as well in order to protect creditors and society.<sup>220</sup> The circumstances that must concur to trigger the piercing of the corporate veil on grounds of alter ego are:

- There must be such a unity of interest and ownership that the separate personalities of the corporation and the individual no longer exists;
- And secondly, if the acts are treated as those of the corporation alone, an inequitable result will follow.

This test, on which is founded the alter ego, was applied in the case of *Van Dorn Co. v Future Chem. & Oil Corp.* In this case, the claimant seeks to recover money owed to him by the defendant company. The claim was based on an allegation of breach of contract and fraud. The majority of shares of the defendant company called “Future Chemical” and the other company involved (called Sovereign Oil Company) were owned by one individual who was also the president of both companies. Among the issues analysed by the court was whether the evidence provided was sufficient to justify piercing the corporate veil. In this case, the court regarded that corporate formalities such as shareholders’ and directors’ meetings, were not complied with. Moreover, assets of both companies were intermingled. The court considered that both companies were dominated to the point that their separate existences could not be recognised. In this case the court made reference to the fact that “*A corporate entity will be disregarded and the veil of limited liability pierced when two*

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<sup>219</sup> See, Rudorfer, M. *Supra note* 196. At page 4

<sup>220</sup> Ballantine, H. **Ballantine on Corporations** (re.ed.1946). Cited by *Idem*. At page 5

*requirements are met: First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporations] no longer exist, and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.*"<sup>221</sup> The precedent established in the *Van Dorn Co.* case pointed to the fact that unity of interest and fraud are adequate justification to ignore the corporate personality. Moreover, in this precedent the court laid emphasis on the fact that both factors must concur in order to ignore the corporate personality.

The alter ego approach has been applied in more recent cases such as *Semmaterials, L.P. v Alliance Asphalt, Inc.*<sup>222</sup> In this case, the claimant sought to enforce a judgment against the company Alliance Asphalt Inc. However, the defendant company could not pay the sum requested in the judgment. Therefore, actions were taken against the shareholder controllers. Based on the evidence, the shareholder controllers did not comply with corporate formalities; no shares were issued and shareholders' assets were commingled with corporate funds. Moreover, there was an intention to dissolve the corporation and "rename" the corporation as a new company, engaging in the same type of business as previously (now with a new name). The court decided to consider the defendant company as the alter ego of its controller shareholders and allowed the claimant to enforce its judgment against the shareholders' assets. The court, in this case, considered that preserving the corporate veil would have produced an inequitable result.

The factors that are observed in order to confirm the concurrence of the circumstances required by the test are usually under-capitalisation, failure to observe records of corporate formalities, non-payment or overpayment of dividends or large withdrawals of corporate assets.<sup>223</sup> Some of the courts that have applied this approach are in California and New Jersey.<sup>224</sup>

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<sup>221</sup> *Van Dorn Co. v Future Chem. & Oil Corp.*, 753 F.2d 565, 569-70 (7<sup>th</sup> Cir. 1985) At page 570

<sup>222</sup> *Semmaterials, L.P. v Alliance Asphalt, Inc.*, 2008 WL 161797 At page 4

<sup>223</sup> See, Rudorfer, M. *Supra note* 196. At page 5

<sup>224</sup> See, Blumberg, Ph. **Blumberg on Corporate Groups**. 2th Edition. U.S.A: Aspen Publishers; 2005. At page 11.01 [A][2], 11-9 to 9

### 2.2.2.2 Instrumentality Doctrine

The instrumentality doctrine is an approach created to deal with corporate veil issues mainly within the context of corporate groups. Frederick Powell firstly proposed this doctrine in 1931; his objective was to formulate a clear rule for piercing the corporate veil.<sup>225</sup> In the case *Lowendahl v Baltimore & Ohio Railroad*, the approach proposed by Powell was applied and the precedent established in this case became reference for its later application.<sup>226</sup> In this case, two insolvent individuals transferred all their assets to a newly created corporation in exchange for forty-nine per cent of the shares. The company, *Baltimore & Ohio Railroad*, owned the remaining fifty-one per cent of the shares. After the claimant, *Lowendahl*, could not recover his credit from the individuals and the transferee corporation, he sued *Baltimore & Ohio Railroad*. The claimant argued that the transferee corporation was controlled by *Baltimore & Ohio Railroad* and requested to pierce the corporate veil to recover from *Baltimore & Ohio Railroad*. In this case, the court refused to pierce the corporate veil. Firstly, the court considered that the defendant company had no direct relation to the scheme designed by the individuals. Secondly, the court also found that *Baltimore & Ohio Railroad* did not control the company at the time of the fraudulent transfer. Citing Powell, the Court established that the party seeking to disregard the corporate entity must prove:

- The parent controls and dominates the subsidiary to such a degree that the subsidiary is a mere “instrumentality” of its parent.
- Through the domination and control of the subsidiary, the parent is perpetrating a fraud or working an injustice.
- These elements result in an unjust loss or injury to the complainant.

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<sup>225</sup> Powell, F. **Parent and Subsidiary Corporations: Liability of a Parent Corporation for the Obligations of its Subsidiary**, §§ 5,6 (1931). Cited By Blumberg, Ph. **The Law of Corporate Groups**. U.S.A: Aspen Publisher; 2007. At page 1.02.1

<sup>226</sup> *Lowendahl v Baltimore & Ohio Railroad* 247 A.D. 144, 287 N.Y.S. 62, aff'd, 272 N.Y. 360, 6 N.E.2d 56 (1936).

Under the instrumentality doctrine, the complete domination over the corporate entity by its shareholders has to be observed. However, it is important to point out that the ownership of majority or complete stock is not strong enough proof of dominance. In order to determine whether a company is an instrument of dominant shareholder(s), factors such as gross under-capitalisation or limited decision-making ability of the corporation must concur. In a relationship between a parent company and a subsidiary, dominance is likely to be determined by factors such as same directors and officers working in the parent and the subsidiary, lack of the subsidiary's proper business and complete financing of the subsidiary through parental enterprise.<sup>227</sup>

Following the dominance over the corporate entity, it also must be proven that influence over the company is used to achieve a wrongful or inequitable result.<sup>228</sup> There is not a clear definition of fraud or wrongful conduct in this context. Consequently, American courts have been liberal in defining the type of behavior that can be considered as wrong in this context, for example: wilful breach of contract, asset stripping and even wrongful discharge of an employee.<sup>229</sup>

The third point required by the instrumentality doctrine requires a connection between the dominance and fraud with the injury or loss sustained by the party seeking to pierce the corporate veil. Differing from the alter ego approach, causation is an element that tends to be regarded by the courts that apply the instrumentality doctrine. A recent case in which the wrongs required by the instrumentality doctrine are considered is *Fantazia International Corp v CPL Furs New York Inc.*<sup>230</sup> In this case, *Fantazia* entered into a contract with CPL for the distribution and sale of CPL products in exchange for sales commission. However, a dispute arose regarding the sales commission. Thereafter, *Fantazia* started proceedings to recover unpaid commissions and also alleged that CPL was dominated by its parent company to the point that both entities should be regarded as a single economic unit. However, *Fantazia* failed to prove domination of the parent over the subsidiary and whether the

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<sup>227</sup> See, Krendl, C. **Piercing the Corporate Veil: Focusing the Inquire.** *Denver Law Journal.* (Volumer 55) 1978. At page 5

<sup>228</sup> See, Cheng, T. **Form and Substance of the Doctrine of Piercing the Corporate Veil.** *Mississippi Law Journal.* (Volume 80) 2010. At page 505

<sup>229</sup> See, Vandekerckhove, K. *Supra note 74.* At page 81

<sup>230</sup> *Fantazia International Corp v CPL Furs New York Inc.*, 67AD 3d 511 – NY Appellate Div., 1<sup>st</sup> (2009)

relationship between parent and subsidiary was the cause for its loss. In this case, the claimant could not comply with the wrongs established in the instrumentality doctrine: control, fraud and causation. Although, this case did not present a successful claim to pierce the corporate veil, it presents an example of the use of the instrumentality approach to determine whether or not to pierce the corporate veil.

The instrumentality doctrine is an approach applied mainly in the context of corporate groups and has been applied by courts in New York and Florida.<sup>231</sup>

### 2.2.3 Reality of the American Doctrine

The American standard to pierce the corporate veil seems simple and easy to apply. Indeed, if the shareholder has complete domination over the corporation used to commit fraud, which proximately caused a plaintiff's injury, the veil will be pierced. However, in practice it is not that simple. In fact, to prove each of these elements is complicated in some circumstances. An example is the case *Walkovsky v Carlton*.<sup>232</sup> In this case, Mr. Walkovszky was injured in a taxi accident. The taxi which injured Mr. Walkovszky was owned by a company called Seon Cab Corporation. Seon Cab Corporation was part of a group of ten corporation owned solely by Mr. Carlton. Each corporation owned only two taxis and carried a lawful minimum insurance of \$10,000 per taxi. All the companies operated as a unit and the working capital of the companies was kept to a minimum. Mr. Walkovsky received insufficient compensation from Seon Cab Corporation. Therefore, Mr. Walkovszky sought to recover the full amount of medical costs as well as compensation for damages. However, even if all the assets of the ten companies were joint, it would not be enough to satisfy the claim. Therefore, he claimed for Mr. Carlton to be liable as well. However, the court considered that there was no fraudulent intention from Mr. Carlton since he had incorporated and followed that established by the law; i.e. the companies had the minimum insurance and capital which, according to law, is necessary for a company to operate in the State of New York. Unquestionably, Mr. Carlton had a high degree of control over the company's part of the group, a factor that makes the piercing of the corporate veil more probable, yet there was no proof of

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<sup>231</sup> See, Blumberg, Ph. *Supra* note 224. At § 11.01 [A][2], at 11-5

<sup>232</sup> *Walkovsky v Carlton* 18 N.Y.2d 414 (1966)

fraudulent intention on the part of Mr. Carlton. The fact that he complied with capital requirements established by law was evidence that he operated his companies in a legitimate manner.

As a personal observation, the standard was designed and aimed to deal with the corporate veil in the context of fraud rather than a situation such as the one presented in the *Walkovsky v Carlton* case. Certainly, it may be difficult to prove the concurrence of fraud as in the previously cited case of *Sea-Land Services v Pepper Source*. However, the piercing of the corporate veil in a case involving fraud is more likely than in one that involves tort.

#### 2.2.3.1 Contract and Tort Cases

The piercing of the corporate veil in the U.S. has been classified in contract and tort cases. This classification derives from the different circumstances presented in both contexts. On the one hand, in a contractual relationship both parties agreed to deal with each other. Therefore, the plaintiff is a voluntary creditor that has chosen to deal with the corporation. The creditor has the opportunity to investigate the company and to choose whether or not to contract. Moreover, the creditor can establish measures to secure its credit, such as higher interest rates or to ask for a personal guarantee from the shareholder. On the other hand, a tort victim is a person who has been harmed by the activities of the company and had no previous relationship with the company. Contrary to a voluntary creditor, a tort victim did not have the opportunity to negotiate and take guarantees to secure proper compensation; rather, a tort victim becomes involve by casualty and there is a probability that the company may not have enough assets to compensate.

Logically, the piercing of the corporate veil should be applied straight away in a case where a person or group of people has been harmed by the activities of a company that do not have enough assets to compensate the victims. However, the reality is that American courts do not frequently pierce the corporate veil in tort cases; rather, the piercing of the corporate veil is likely in a contract case.<sup>233</sup> This has been the subject of criticism by American academia. Some academics have even argued

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<sup>233</sup> See, Millon, D. *Supra note 6*. At page 1318-1325

that the corporate veil should be invalid in the context of tort.<sup>234</sup> However, in spite of the criticism, American courts are currently more likely to disregard the corporate personality in contracts than in tort cases.

Contract cases can be considered to provide a stronger basis to pierce the corporate veil than do tort cases. Firstly, courts in the U.S. require the concurrence of fraud or inequitable conduct, which is more probable to find in a contract case than in a tort case. An example is in the case *Roofing Ctr. V On Top Roofing, Inc.*; the claimant purchased materials that were used for work with customers but the profits were spent on high salaries and extravagant rents. Consequently creditors were not paid and the court allowed the piercing of the corporate veil.<sup>235</sup> Indeed, a voluntary creditor is more likely to be affected by fraud or reckless behavior, thus demonstrating the use of the corporate form to undermine the bargaining that has gone on between the company and its creditors. Secondly, due to the different nature of the relationship between the corporate entity and the tort victim, the piercing of the corporate veil tends to be decided on whether or not the corporate formalities were followed by the members of the company.<sup>236</sup> However, corporate formalities are normally followed, therefore complicating the development of an argument to support the application of this remedy. The previously cited case of *Walkovszky v Carlton* is an example. Mr. Carlton undoubtedly created the companies to benefit from the corporate personality and limited liability. However, he complied with the requirements established by the law. Although, the compensation paid by the insurance was small, Mr. Carlton complied with the minimum established by the law. To look at corporate formalities to determine whether or not to pierce the corporate veil in the context of tort has been the subject of criticism due to the fact that the veil may be pierced under circumstances that have no relation to the cause that produced the harm or injury.<sup>237</sup>

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<sup>234</sup> The commentators Henry Hansmann & Reinier Kraakman are some of the academics in favor creating liability for corporate torts. They propose that limited liability must be abolished, at least as to certain types of creditor claim. See, Hansman & Kraakman. **Towards Unlimited Liability for Corporate Torts.** *Yale Law Journal.* (Volume 100) 1991.

<sup>235</sup> *Roofing Ctr. V On Top Roofing, Inc.* 807 S.W.2d 545, 547 (Mo. Ct. App. 1991)

<sup>236</sup> See, Barber, D. **Piercing the Corporate Veil.** *Williamette Law Review.* (Volume 17) 1981. At page 381

<sup>237</sup> See, Blumberg, Ph. **The Law of Corporate Gorups. Tort, Contract and other Common law Problems in the Substantive Law of the Parent Subsidiary Corporations.** U.S.A: Aspen Publisher; 1987. At page 163

The existence of the corporate veil cannot be abolished in the context of tort because this will undermine the concept of corporate personality. I support this statement on the fact that corporate personality was created to diminish the exposure to the risk involving a commercial adventure. Financial risks are not only in a contractual context but also in the context of tort. Certainly, it may be unjust for the tort victims in cases such as Union Carbide's Bhopal disaster.<sup>238</sup> However, the corporate personality and the attribute of limited liability were created to protect investors and their assets, as is presented on the case *Cotton v Gaylord Container Corp.*<sup>239</sup> In this case a parent company called "Gaylord Container Corporation" and its subsidiary "Gaylord Chemical Corporation" operated next to each other and shared facilities. Nonetheless, each had its own manufacture and sales business independent from each other. Gaylord Container had decided to form Gaylord Chemical as a separate corporation in order to isolate the risk of the separate chemical operation in a separate entity and to protect the rest of its considerable investment in Gaylord Container from any potential creditors of Gaylord Chemical. A chemical disaster happened and the victims sued the Gaylord Chemical. Moreover, the claimants sought to include the parent company in the proceedings by requesting to regard both companies as a single business enterprise. The single business enterprise, or single economic unit, is an approach aimed at disregarding the corporate personality and limited liability protection in the context of corporate groups. However, in order to regard a group as a unit it must be proved that the parent company has somehow abused the corporate form. In the argument made by the claimants, there was no allegation that Gaylord Chemical would not be able to pay the damages nor was there an attempt to prove that there was an abuse of the privilege of incorporation. The claimants instead emphasised the business and physical connections between the two plants, their common ownership and the various means by which the two were operated in a co-ordinated manner. The court decided to maintain the separate existence between the parent and subsidiary based on the fact that there was not a

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<sup>238</sup> "Union Carbide India Limited" (UCIL) was a part of a multinational group of companies. Due to negligence a gas leak produced one of the worst industrial disasters. Legal proceedings were taken by the victims in order to make the holding company "Union Carbide Corporation" (UCC) (which held 51 % of UCIL shareholding). However, On 14 January, 1987 the U.S. Second Circuit Court of Appeals in Manhattan upheld a decision by the U.S. District Court to send the legal case against UCC to India. It ruled UCIL was a separate and independent legal entity managed and staffed by Indian citizens. See, <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC1142333/> [last visit 10 July 2013]

<sup>239</sup> *Cotton v Gaylord Container Corp* 691 So. 2d 760, 763 ( La. Ct. App. 1997)

concurrency of fraud or wrongdoing or abuse of the corporate form by part of the parent company.

The fact that the piercing of the corporate veil is likely to happen in cases involving an issue derived from a contract, evidences that this doctrine has been developed to prevent and punish the unjust enrichment of the shareholders at the expense of the corporation's creditors. In some circumstances, tort victims may not receive proper compensation and shareholders may not be held liable for the harm produced by the activities or products made by the corporation. This is unarguably unfair yet the piercing of the corporate veil was a remedy created without an altruistic purpose.

#### 2.2.4 Agency and Enterprise Liability

The concepts of agency and enterprise liability are other alternatives that have been considered by the U.S. Courts for dealing with corporate veil issues, mainly in the context of corporate groups. The author Kurt Strasser considers these alternatives to the piercing of the corporate veil as “more episodic than systematic”.<sup>240</sup> This statement by Strasser is justification for the fact that agency and enterprise liability are used to validate ignoring the corporate entity in a setting where the piercing of the corporate veil was either not available or not requested by the parties. Moreover, the context in which these approaches are applied does not involve the concurrence of a fraudulent or wrongful action as they are based on the excessive control of one company over another.

##### 2.2.4.1 Agency

In the U.S., the concept of agency has been considered as an alternative route to the imposition of liability upon a parent corporation for the acts of its subsidiary.<sup>241</sup> However, it has been complicated to adapt the concept of agency in this context due to the fact that in the parent-subsidary relationship, agency relationship does not exist. All agency relationships consist of an expressed agreement in which a party called the principal gives authority to another party to act as its agent. All the acts

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<sup>240</sup> See, Strasser, K. *Supra note* 54. At page 645-646

<sup>241</sup> See, Blumberg, Ph. *Supra note* 70. At page 307

made by the agent under the name of the principal will render the former liable. However, this is not the case for corporate groups. As explained in the first chapter of this thesis, corporate groups are based on a group of companies that act under the direction of one company in order to achieve a common purpose.<sup>242</sup> Each of the companies forming the group is considered an independent entity with its own businesses and liabilities. If a parent company contracts its subsidiary to act as its agent, the former will be held liable for the acts of the latter on grounds of agency. Otherwise, “agency” would not be considered an appropriate means for holding the parent company liable.

In cases where a subsidiary is not solely owned by the parent but also has the same directors and is used only to benefit the parent company, it may be argued that the subsidiary is merely an agent of the parent. Moreover, the subsidiary’s attachment to the parent gives ground to argue the existence of implied agency. However, American courts have dealt with parent company’s liability using the doctrines of instrumentality and alter ego rather than using implied agency.<sup>243</sup> Implied agency in this context is based on control and unfairness, which are the grounds on which instrumentality and alter ego are based.<sup>244</sup>

The U.S. courts do not rely on the concept of agency to deal with corporate veil issues. Notably, an approach based on agency has not been widely accepted in the U.S..<sup>245</sup>

#### 2.2.4.2 Single economic unit or Enterprise liability

The “Single Business Enterprise” is a concept aimed at dealing with corporate personality issues in the context of corporate groups. The approach based on this concept does not focus on discussing and questioning separate liability rules for the individual corporate entity and its corporate parent shareholder. However, this approach focuses on the business as a whole and aims to determine whether the corporate group should be regarded as a unit. In order to decide whether the group

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<sup>242</sup> See, **Chapter One**. At page 33-36

<sup>243</sup> See, Barber, D. *Supra note* 236. At page 401

<sup>244</sup> See, Henn, H. **Laws of Corporations and Other Business Enterprises**. 3rd Edition. U.S.A: Student Edition. West Pub. Co.; 1983. At page 258

<sup>245</sup> See, Barber, D. *Supra note* 236. At page 401

should be considered as a unit, the internal organisation and management structure of the enterprise would be taken into consideration rather than the culpability and wrongful conduct involved in the case. Indeed, the approach aimed at regarding a group of companies as a unit can be considered as an alternative to piercing of the corporate veil in the context of tort. The case *In re Oil Spill by the Amoco Cadiz* is an example.<sup>246</sup> The issue in this case derives from a mechanical malfunction of a Super Tanker called *Amoco Cadiz*, which caused the ship to drift and crash into rocks on the coast of Breton, France. The accident produced an oil spill on the coast of France, causing environmental damage and losses for communities in the coast. Therefore, in the U.S Courts the Republic of France and the affected parties started legal action against the companies forming the group to which the *Amoco Cadiz* belonged. The basis of the claim was the negligent operation and faulty design of the Super Tanker. The defendant companies claimed exoneration of liability based on the concept of separate corporate personality. The court evaluated facts such as the duty of the subsidiaries to provide proper maintenance in order to maintain the ship seaworthy and the degree of influence the parent company (Standard Oil Company) had over the subsidiaries involved in the case. In this case, the court found the parent company to be liable together with its subsidiaries;

“As an integrated multinational corporation which is engaged through a system of subsidiaries in the exploitation, production, refining transportation and sale of petroleum products throughout the world, Standard is responsible for the tortuous acts of its wholly owned subsidiaries and instrumentalities... Standard exercised such control over its subsidiaries AIOC and Transport that those entities would be considered mere instrumentalities of Standard Oil Company... Standard is therefore liable for its own negligence and the negligence of AIOC and Transport with respect to the design, operation, maintenance, and crew training of the *Amoco Cadiz*”<sup>247</sup>

In the *Amoco Cadiz* case the concept of enterprise liability was presented as a means to address the liability of the group. However, this concept is not normally applied alone. Enterprise liability is applied together with labour and environmental regulations. Labour and environmental regulations contain policies which are aimed

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<sup>246</sup> *Oil Spill of the Amoco Cadiz off the Coast of France* 35 Fed. R. Evid. Serv. 1204 (1984)

<sup>247</sup> *Idem*

at protecting interests that are over the concept of corporate personality. By ignoring the legal personality of the companies part of the group and addressing a corporate group as a unit the liability that exist in cases involving a public interest that has been affected is reinforced.

### 2.2.5 The Current Position of American Courts in Regard of Piercing the Corporate Veil

Throughout this section I have pointed out that some U.S. Courts give different weight to a factor that may not be of interest to another State Court. In this section, the multiple-jurisdiction factor has been evidenced, which is the reason for the piercing of the corporate veil to be a complex subject in the U.S.. However, in spite of differences among State Courts, the American Courts share the contention that a strong justification is required in order to ignore the corporate personality.

The American courts tend to preserve the corporate personality if there is no strong justification to ignore it. An example is the recent decision over the case *Complete Transportation, LLC v. CPM Colchester, et all LLC*.<sup>248</sup> In this case, the claimant seeks to recover his credit from the defendant company, which is an LLC. One core argument used by the claimant is the excessive control the defendant has over the company. In its analysis, the Court cited the Connecticut General Statute, in particular a section corresponding “Relations of Members and Managers to Persons Dealing with a Limited Liability Company,” and pointed out the liability of members and managers to third parties. In Sections 34-133 (Conn. Gen. Stat. § 34-133), it is established that the liability is limited. The court regarded previous case law and cited passages involving the instrumentality doctrine and the requirements for its application. Case law in this area indicates the fact that “... disregard the fiction of a separate legal entity, to pierce the shield of immunity afforded by the corporate structure in a situation in which the corporate entity has been so controlled and dominated that justice requires liability to be imposed on the real actor.”<sup>249</sup> Based on statements such as this, the Court structured its decision and considered that on

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<sup>248</sup> This case was decided by the Superior Court of Connecticut in February 2013 and may be subject to further appellate review. *Complete Transportation, LLC v. CPM Colchester, et all LLC*. 2013 Conn. Super. LEXIS 342

<sup>249</sup> *Angelo Tomasso, Inc. v. Armor Construction & Paving, Inc.*, 187 Conn. 544, 552, 447 A.2d 406 (1992)

grounds of instrumentality, the plaintiff could not prove the concurrence of wrong other than the defendant company's inability to pay. Thus, the piercing of the corporate veil was denied.

Another example is the case *Joseph Friend, v. Remac America, Inc.*<sup>250</sup> In this case the claimant, while working for the defendant, suffered injuries and claimed compensation. However, the defendant company did not pay proper compensation to the claimant. Thus, the claimant requested the piercing of the corporate veil on the two-prong test (control and fraud) and moreover reinforced his claim on the argument of undercapitalisation and lack of compliance of corporate formalities. The claimant emphasised the lack of a proper insurance coverage to protect employees. However, the Court pointed out that the test with which the claimant wanted to justify the piercing of the corporate veil is applicable to contract cases, not to tort cases such as the then present claim. The court in this case said that the shareholders and managers were not liable for the torts of the company. Moreover, the claimant could not prove undercapitalisation or lack of compliance with corporate formalities. The claimant alleged undercapitalisation based on the fact that the company had not bought enough insurance cover. The Court considered the claimant's claim inadequate and decided not to pierce the corporate veil.

In the case *Jaclinn Pulman v Alpha Media Publishing INC* the exceptional nature of piercing the corporate veil is also present. In this case the claimant presented her claim in New Jersey Courts.<sup>251</sup> The claimant invested in a bungalows project and was told that a company called Maxim owned the bungalows. The Claimant trusted the company and felt secure because she had the impression she was investing with a solid company. However, the claimant researched the project and discovered that Maxim was not the owner of the project. Moreover, she lost her money when it was revealed that the bungalows project was a Ponzi scam. The claimant sued a group of companies involved based on the fact that she was fraudulently misrepresented and also requested the piercing of the corporate veil. The New Jersey court required the concurrence of control and the use of the influence over the company to achieve

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<sup>250</sup> *Joseph Friend, v. Remac America Inc., CIVIL ACTION NO. 3:12-CV-17*

<sup>251</sup> *Jaclinn Pulman v Alpha Media Publishing INC* 2013 U.S. Dist. LEXIS 50697

fraud. The claimant alleged that the defendant created a cluster of companies in order to carry out the scam. However, the claimant pleaded the piercing of the corporate veil as a separate cause of action. Consequently, it was denied. The piercing of the corporate veil is not considered as a cause of action in New Jersey courts.

The three cited examples present three different circumstances in which the piercing of the corporate veil is denied. In these three cases, the claimants presented poor justification for piercing the corporate veil. American Courts are willing to ignore the corporate personality if it is improperly used. In these cases, the courts evaluated and considered the application of this remedy. However, to pierce the corporate veil the American Courts require strong justification.

#### 2.2.6 The Piercing of the Corporate Veil in the Context of American Statutory Law

In the U.S the piercing of the corporate veil has been developed as a doctrine but not as a statutory rule. As previously mentioned, company law in the U.S is a matter regulated by each state. Consequently, since the early days of American Company Law, states have competed to develop an environment favourable for the incorporation of companies. Notably, the incorporation of companies represents a profitable business for the State and its inhabitants. Therefore, in order to attract investors, states' corporate laws have been drafted focusing on aspects such as the preservation of the corporate veil.

Currently, there is not a direct exception to the corporate personality in U.S Company Laws. However, this does not mean that a measure to enforce public policy has not been taken. The author Harry G. Henn comments: "The corporate entity will be recognized, but will not be permitted to be a device to defeat public policy."<sup>252</sup> The statement made by Henn is shared in this thesis. Indeed, in the first chapter it is stated that a public interest protected by a public policy will prevail over the corporate personality.<sup>253</sup> The State has a duty to protect public interests and a statutory rule is a means used by the State to fulfill its duty to protect the public interest. The U.S tax

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<sup>252</sup> See, Henn, H. *Supra* note 244. At page 359 §150

<sup>253</sup> See, **Chapter One**. At page 30-32

law, labour law and environmental law are areas in which the corporate personality is likely to be ignored by the U.S. authorities in order to enforce a public policy.

#### 2.2.6.1 Tax Law

In the context of tax law, for state and federal tax purposes, the corporate entity is usually recognised, although disregarded when used as a tax-evasion device.<sup>254</sup> Originally, tax law was silent in respect of this matter. However, the decision of the U.S Supreme Court on the case *Higgings v. Smith* shed light on this subject.<sup>255</sup> In this decision it was established that the government might disregard sham corporations whenever that would best serve the purpose of a tax statute and that a taxpayer who has chosen to do business as a corporation must accept any tax disadvantage of that form.<sup>256</sup> In other words, the taxpayer will not be permitted to renounce the corporate entity for their benefit.

#### 2.2.6.2 Labour Law

Corporate personality may produce different questions in the context of labour law cases; for example, to what extent should a parent company accept responsibility for their subsidiaries' unfair labour practices? Alternatively, to what extent should a collective bargaining agreement covering the employees of one corporation be extended to cover another nominally separate yet still commonly owned entity? However, although there have been questions and reflections on this subject, the public interest which exists regarding the protection and enforcement of workers' rights tends to prevail over the corporate personality dilemma. The U.S Federal Courts have assumed the task of formulating a federal common law of labour relations, a fact that has left many aspects of the employment relationship subject to exclusive federal control and furthermore to be entirely immune from state regulation.<sup>257</sup> The National Labour Relations Act (NLRA) is a regulation that deals with collective bargaining agreements, working hours, employment discrimination and wages. The NLRA is one of the most notorious regulations that has been

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<sup>254</sup> See, Henn, H. *Supra note 244*. At page 372§153

<sup>255</sup> *Higgings v. Smith* 308 U.S 473, 60 S.Ct. 355, 84 L.Ed. 406 (1940). Cited by Henn H. *Idem*. At page 373

<sup>256</sup> *Ibid*

<sup>257</sup> See, Mcleod, W. **Shareholder's Liability and Workers' Rights: Piercing the Corporate Veil Under Federeal Labor Law**. *Hofstra labor law*. (Volume 91) 1991-1992. At page 117

developed and applied in labour cases involving the corporate personality. From the application of the NLRA in corporate personality cases, the concepts of “single economic employer” and “alter ego” have been introduced to American labour law. The former is based on determining whether nominally independent enterprises are sufficiently intertwined and whether they should be considered a single employer for NLRA purposes. The latter seeks to determine whether the existence of a corporate entity is an attempt by the employer to avoid obligations. Both approaches focus on review aspects concerning management and corporate formalities. Moreover, it can be considered that the single economic employer is founded on the approach developed from the concept of a single economic unit previously mentioned. Indeed, the single economic employer transfers liability to the companies forming the group as if they were a whole.

As a personal observation, the application of the NLRA can be considered as an attempt to make the piercing of the corporate veil in labour law cases coherent. The corporate personality cannot be disregarded in every labour controversy because doing so would affect its integrity. Certainly, workers’ rights take priority due to the public interest that exists regarding the enforcement of these rights. However, there must also be a rational justification for the use of this remedy. Therefore, through the application of the rules contained in the NLRA, the U.S judiciary has introduced the single economic employer and alter ego approach to systematically apply this remedy in this context.

It is worth adding that approaches formulated from the application of the NLRA have been applied together with other labour statutes such as the WARN Act (workers Adjustment and Retraining Notification)<sup>258</sup> and ERISA (Employment Retirement Income Security Act).

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<sup>258</sup> The WARN Act of 1988, 29 U.S.C. §§ 2101-2109, requires certain employers, inter alia, to provide their employees with sixty days prior notice before engaging in a plant closing or other large layoff. Since the WARN Act only applies to businesses with one hundred or more employees, veil piercing and single enterprise issues arise when affiliated corporations individually fall below the threshold but together aggregate the requisite number. See, Presser, S. **The Bolgalusa Explosion, “Single Business Enterprise” “Alter Ego” and other error: Academics, Economics, Democracy and Shareholder Limited Liability. Back Towards a Unitary “Abuse” Theory of Piercing the Corporate Veil.** *Northwestern University law Review.* (Volume 100). 2006. At page 416

### 2.2.6.3 Environmental Law

In the U.S. the piercing of the corporate veil in statutory interpretation is best illustrated in the field of environmental law; indeed, during the 1970s concern for the environment started to arise in the mind of the American public.<sup>259</sup> The Comprehensive Environmental Response, the Compensation and Liability Act (CERCLA), was a product of the concern regarding the need for a rule to deal with the release of hazardous substances. The rationale of CERCLA was based on a public policy aimed at the protection of the environment. However, Federal Courts in this context do not disregard the legal entity straight away. In CERCLA liability is imposed depending upon four circumstances but for the purposes of this section, only the first one will be addressed. It has been established that the owner and operator of a polluting vessel or facility will be liable for environmental contamination.<sup>260</sup>

The U.S is known for its strong industry, which has been developed through the use of corporate groups. Many industrial activities involve hazardous practices and in cases of environmental disasters, parent companies and other subsidiaries part of the group are free of liability thanks to the group's structure. In some circumstances, the affected parties seek to make the parent company liable; thus the concept of operator established in CERCLA has been used to support an action against a parent company. The use of the concept of operator derives from the fact that subsidiaries operate under the instructions of the parent. However, to address the parent corporation under the concept of operator contained in the Act is complicated because a subsidiary, in principle, operates as an independent entity from its parent and the influence of the parent over the subsidiary is the product of an agreement between both in order to achieve a common purpose. Moreover, in the Act there is not a clear definition of what can be considered as an operator in this context. Therefore, the alter-ego doctrine has been employed to supplement the concept of operator in order to enforce the policies contained in CERCLA.<sup>261</sup> The use of the test contained in the alter-ego approach can be considered as a better means to determine parent liability for the

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<sup>259</sup> See, Noonan, P. **Pierce or not to Pierce? When, is the the question. Developing a Federal Rule for Piercing the Corporate Veil Under CERCLA.** *Washington University Law Quarterly*. (Volume 60) 1990. At page 735

<sup>260</sup> Section 107 (a)(1) of CERCLA, 42 U.S.C § 9607 (a)

<sup>261</sup> See, Noonan, P. *Supra note 259*. At page 741

subsidiary's actions. By evaluating aspects such as compliance with corporate formalities and financial independence, the degree of control of the parent over the subsidiary can be determined thus establishing whether the parent company can be viewed as operator or not.

The previously cited case of *The United States v Bestfoods*<sup>262</sup> is a relevant case in this area. In this case the court dealt with the dilemma about whether the parent company could be considered as an operator for the purposes of CERCLA. Moreover, the court tried to provide a definition of operator in this context. To deal with the concept of corporate groups is complicated but the precedent in *United States v Bestfoods* has provided a reference for contemporary cases; an example being *AMW Materials Testing, Inc v. Town Babylon*.<sup>263</sup> In this case a fire produced the release of a hazardous substance kept in a building owned by the defendant. Thus, the claimant sought to hold the defendant liable on grounds of the concept of operator contained in CERCLA and the precedent set by *United States v Bestfoods*.

#### 2.2.7 The Role of the Concepts of Fraud and Negligence the Context of Corporate Veil issues

Among the imperfections of the U.S. doctrine of piercing the corporate veil, one aspect that should be analysed is the use of the remedy to deal with corporate veil issues derived from damages produced by negligence. In this thesis it is considered that corporate personality issues involving fraud must be handled separately from cases involving negligence. To include the concept of negligence together with fraud is not appropriate because negligence involves an issue where producing loss or harm is unintentional. The issue on mixing the concepts of fraud and negligence lies in the fact that it complicates the application of a remedy such as piercing the corporate veil, which was originally created to deal with the fraudulent use of the corporate entity.

If the corporate personality is used to achieve a fraudulent purpose this will be ignored; this is the premise on which the piercing the corporate veil has been built. The application of this remedy in cases in which a fraudulent intention does not exist has contributed to the uncertainty that surrounds this subject. The omission of the

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<sup>262</sup> See, *Supra note 208*

<sup>263</sup> *AMW Materials Testing, Inc v. Town Babylon*, 584F. 3d 436-Court of Appeals, 2<sup>nd</sup> Circuit 2009

original trigger (fraudulent behaviour) makes the piercing of the corporate veil void of its original purpose (punishment and prevention of fraud) and renders this remedy unpredictable. Some American academics consider the unpredictability of the doctrine as convenient because it encourages wrongdoers to abstain.<sup>264</sup> However, in this thesis unpredictability is considered a factor that undermines the concept of corporate personality because it gives room for the application of piercing the corporate veil in circumstances that do not necessarily require this remedy.

Currently, the piercing of the corporate veil has been considered as a last resort, due to its unpredictability.<sup>265</sup> As mentioned, the exceptional circumstances are based mainly on the concept of fraud. If this trigger is omitted, it gives room for an uncontrolled and unjustified application of this remedy.

As stated, corporate entity issues derived from fraud and those derived from negligence should not be confused. However, what is negligence in this context? In this thesis the concept of negligence refers to the harm produced by reckless management and tort damages produced by the practice of dangerous activities. Reckless management produces harm to different parties that have a direct relation with the corporate entity, for example, workers may not get their wages and creditors may not recover their credit because the company ran out of assets due to irresponsible management. The inadequate practice of dangerous activities, on the other hand, generally consists of damages to parties that do not have any relationship with the corporate entity; for example, a chemical disaster that affects a town and pollutes the environment. However, there are also cases in which dangerous activities may affect parties that have a direct relationship with the entity such as the employees, who may be affected if the company does not comply with security requirements.

The objective of the corporate entity is to protect shareholders from these situations. However, to preserve the corporate personality presents a dilemma based on the unfair result that may be produced in some circumstances if the corporate personality is preserved. This “fairness dilemma” can be considered as the reason for

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<sup>264</sup> See, Bainbridge, S. *Supra note* 119. At page 46-49

<sup>265</sup> See, Bevens, N. *Supra note* 37. At page 275

the concept of negligence to be considered when dealing with corporate personality issues. Currently, in the U.S. the piercing of the corporate veil has been requested by affected parties in cases where no fraudulent behaviour was seen to have existed; a factor that can be attributed to the mix of the concepts of fraud and negligence when talking about corporate personality issues. However, it is likely that the U.S. courts will deny the piercing of the corporate veil if there is no fraud or an evident inequitable result. Evidence of this can be found in an example such as the case *McCloud v Bettcher Industries Inc.*<sup>266</sup> The claimant in this case worked for a subsidiary and sustained injury while operating a bread machine. Therefore, the claimant sought to pierce the corporate veil to hold the parent company liable together with his employer. However, the Court considered that the parent as a shareholder could not be held liable for the torts of its subsidiary. The court maintained that a party seeking to pierce the corporate veil must establish that the owners, through their domination, abused the privilege of doing business in the corporate form, thereby perpetrating a wrong that resulted in injury to the affected party. In this case there was not an abuse of the corporate form. Another example can be found in the case *Smith v Delta*, decided by the New York Court.<sup>267</sup> In this case the claimant was injured while working for a company managed by the defendant. The claimant claimed for compensation not only against the employing company but also the defendant company and individual parts of this entity. However the claimant failed to justify on what grounds the corporate veil should be pierced in this case. He did not prove that the defendant failed to adhere to corporate formalities, inadequate capitalization or commingled assets. The court considered that a party seeking to pierce the corporate veil must establish that the owners, through their domination, abused the privilege of doing business in the corporate form by perpetrating a wrong or injustice against the affected party.

In these two examples the piercing of the corporate veil was denied based on a lack of consistent argument to justify the application of this remedy. The purpose of citing these cases is to show the concurrence of pleas based on a cause that does not involve fraud. To allow and reflect over the piercing of the corporate veil in cases where no fraudulent behaviour exists creates uncertainty. Indeed, the fact that a court

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<sup>266</sup> *McCloud v Bettcher Industries Inc* 90 AD 3d 1680- NY Appellate Div., 4<sup>th</sup> Dept 2011

<sup>267</sup> *Smith v Delta Intl, Mach, Corp.*, 2010 NY: Appellate DIV., 2<sup>nd</sup> Dept 2010

considers this action without the concurrence of the original trigger creates a perception that this doctrine may be applied whenever it is summoned.

Although the concept of negligence has been considered by the U.S doctrine, the corporate personality issues in this context have been handled in a more practical way in certain areas of law; for example, damages derived from reckless management in the context of public companies. In this context, hired directors rather than shareholders manage modern U.S companies. These hired directors do not receive the benefits of the corporate personality and limited liability, as do the shareholders. Consequently, authorities do not need to deal with the corporate veil in this situation. For this task, accountability and management regulations have been developed in order to deter and penalise reckless management. An Example is the American “Sarbanes Oxley Act”, a regulation that strengthens accountability controls, increases the oversight role of boards of directors and renders the penalties for fraudulent and negligent activities more severe.<sup>268</sup>

The existence of statutes aimed at dealing with reckless management in the context of public companies evidences the existence of a more practical method to deal with corporate personality cases where no fraudulent behaviour exists. In other words, a statutory approach in this context can be considered as more practical. If statutory exceptions were developed in critical areas such as reckless management and environmental law, the piercing of the corporate veil would be a less uncertain subject.

Some civil law jurisdictions have been practical and have handled issues derived from negligence in statutory rules. An example is Brazilian environmental law in which it is established that the corporate entity will be ignored in cases involving damages to the environment.<sup>269</sup> As it has been mentioned throughout this thesis, civil law jurisdictions adhere to positive law. Definitely, this is an influential factor for the development of a statutory exception to the corporate personality. However, the existence of an exception to the corporate veil in Brazilian environmental law can be attributed to the need of a rule aimed at helping to enforce public policies in this area

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<sup>268</sup> **Sarbanes–Oxley Act of 2002** (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002)

<sup>269</sup> See, **Chapter Three**. At page 151-156

of law. The concurrence of negligence is common in environmental disasters. To use this as a remedy for piercing of the corporate veil is not suitable for this sort of circumstance. Consequently, it is appropriate to apply a direct statutory exception in this context.

It is important to add that the development of a rule to deal with the corporate personality in a case that does not involve fraud must be based on the legal framework and legal needs of each jurisdiction. As I emphasise throughout this thesis, economic development has strong influence over the corporate personality and all the aspects that surrounds this concept.

My case study, Panama, is a jurisdiction in which the piercing of the corporate veil has been recent. Panama has developed as a financial service provider. Industrial activity does exist in this country but on a small scale in comparison to industrialised countries. Moreover, companies tend to be private rather than public. The existence of more private companies can be attributed to the fact that funding can be gathered from local banks.<sup>270</sup> The existence of a small capital markets with few public companies and little industrial activity makes the concurrence of reckless management and tort damages infrequent issues. As I have mentioned, an approach to piercing the corporate veil must be based on the legal framework and the usage that is given to the corporate entity. In Panama, the joint stock corporation has been developed in an environment that allows the corporate entity to be used in a way that makes the concurrence of fraudulent intention likely. Certainly, it cannot be denied that cases involving loss or harm produced by negligence may arise. For example, reckless management may leave workers without payment. However, Panamanian labour law has already included a mechanism to deal with this issue and does not necessarily involve engaging the corporate veil dilemma. The rule contained in the Article 92 of the Panamanian Labour Code not only allows the setting aside of the corporate personality on grounds of fraud but also on grounds of negligent management causing the company's impossibility to pay its employees.<sup>271</sup>

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<sup>270</sup> See, **Chapter Four**. At page 161

<sup>271</sup> See, **Chapter Four**. At page 175-176

The piercing of the corporate veil as a remedy based on the prevention and punishment of fraud should have the scope for its application limited to this context. To attempt to pierce the corporate veil in situations that do not involve fraud, creates uncertainty because there will be no specific ground for the application of this remedy. Moreover, it contradicts the exceptional nature of this remedy by allowing parties requesting its application whenever they want, a fact that definitely would undermine the concept of corporate personality.

## Summary

The U.S. is a jurisdiction that presents a complex legal system. Unquestionably, the plurality of state jurisdictions and a federal jurisdiction have generated different opinions and perspectives about the piercing of the corporate veil. However, despite the doctrines of instrumentality and alter-ego being considered as the only systematic approach to deal with corporate veil issues, they present a set of circumstances that have to concur in order to ignore the corporate personality; namely, the main trigger, which is the concurrence of wrongful and fraudulent behavior. Nonetheless, there have been cases involving corporate personality issues that have not necessarily involved the concurrence of a fraudulent behavior. Consequently, the American judiciary has also relied on other approaches to deal with corporate entity issues such as agency and the single economic unit. In the context of statutory law there is no direct exception to the corporate personality. However, this can be ignored based on public policies aimed at protecting a public interest.

### **2.3 Why does the U.S. appears more willing than England to pierce the corporate veil?**

The U.S. and England are common law tradition countries, have strong markets and prosperous economies. The corporate personality has been key in the development of these countries.<sup>272</sup> Consequently, both tend to respect the integrity of the corporate personality. However, when it comes to situations that involve an improper use of the corporate personality, the U.S. has evidenced more willingness to ignore the existence of the corporate personality than England. In fact, the piercing of the corporate veil has been a common issue in U.S. company law. This chapter has addressed the American doctrines of instrumentality and alter ego. Both doctrines are the result of rich case law on piercing the corporate veil.

However, the fact that the U.S. has developed to a greater extent the doctrine of piercing the corporate veil does not mean that the U.S. authorities will pierce the corporate veil whenever this action is requested. The U.S. authorities tend to preserve the integrity of the corporate personality. Nonetheless, it has been perceived that the U.S. is a jurisdiction willing to pierce the corporate veil because a series of factors that make this subject gain more relevance in the U.S..

The U.S. has a federal government a fact that in turn makes the U.S. a complex jurisdiction. Company law and all the aspects related to it have been left as a matter for each state to regulate. Consequently, each state has a different opinion about the piercing of the corporate veil. Certainly, the doctrines of instrumentality and alter ego are structured on the same concepts: control, fraud and causation. However, each state has its own perception of each of these concepts. Moreover, when corporate personality issues go beyond state borders, conflicts of laws arise not only between state laws but also between state law and federal law. As a result, the diversity of opinions and constant debates about piercing the corporate veil stimulate the development of this subject. In contrast, England has a more centralised type of

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<sup>272</sup> See, Micklethwait, J and Wooldridge, A. *Supra note 43*.

government. As a consequence, court decisions tend to have a more uniform effect than in the U.S. Evidence of this is the English case of *Salomon v Salomon Co.* In England, the precedent established in the Salomon case is the foundation of the current position regarding the piercing of the corporate veil, the preservation of the corporate personality. It cannot be denied that among the English judiciary and academia there have been different opinions on this subject. However, the general tendency is to follow the precedent established in the case of Salomon.

In addition, another factor that has to be considered is the perception of the concept of fairness in this context. It can be considered that English authorities tend to be stricter than the U.S. An example is the previously cited case of *Adams v Cape*. In this case, the U.S. authorities decided to hold Cape Industries liable. However, when English authorities were requested to recognise and enforce this judgment, they refused to do so. Their refusal was based on the lack of a strong justification to ignore the corporate personality. The U.S. authorities tend to consider the piercing of the corporate veil in cases that do not necessarily involve a fraudulent or wrongful conduct. In contrast, English authorities emphasised in the case of Cape that the corporate veil should not be pierced merely because it is just to do so.<sup>273</sup>

The U.S. and England share the same legal tradition and the corporate personality has been relevant to their economies. However, the geographical dimension, organisation of government and judiciary and the role of the concept of fairness are factors that in this thesis are considered to have had an effect over the piercing of the corporate veil in the U.S. and England. These factors are of special attention because they are precisely what make each of these jurisdictions unique.

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<sup>273</sup> *Adams v Cape Industries* [1990] B.C.C. 786. At page 544-545

### 2.3.1 The Dilemma between the “Sledge Hammer Approach” and the “Back Door Approach”

The piercing of the corporate veil is a subject that has been regarded differently in the U.S. and England. As stated in Chapter One, the piercing of the corporate veil is a remedy that each jurisdiction adapts in accord to its legal needs. The “sledge hammer approach” and the “back door approach” are names used in this section to address the different paths that the U.S. and England have taken to pierce the corporate veil. I address both approaches under these headings for the purpose of this section, which is to determine what can be the most suitable position for my case study, Panama. I am not arguing that Panama should copy the American or English approaches; rather my intention is to present my opinion about whether Panama should be active or passive with regard to corporate veil issues (the Panamanian corporate personality and the piercing of the corporate veil is a subject that will be properly addressed in Chapter Four).

On the one hand, the U.S. deals in a straightforward manner with the corporate personality. The doctrines of instrumentality and alter ego are a means to piercing the corporate veil. Hence, it can be considered as a jurisdiction that has used a “Sledge Hammer approach” because it directly strikes the concept of corporate personality. England, on the other hand, has opted for not attacking the corporate personality but instead looking for alternative ways in which to deal with corporate veil issues. In this chapter, it was noted that English cases dealing with corporate personality issues did not finish with piercing of the corporate veil. The fact that the integrity of the corporate personality has not been affected makes this a “back door approach” because it looks for an alternative, less direct, means to establish liability for the corporation’s acts.

These different approaches trigger the following question: which approach provides a more suitable basis for the Panamanian approach? Some may argue that a “back door approach” is more convenient for Panama in view of the fact it is a financial service provider and relies on the incorporation of companies. A “back door

approach” will not worry investors nor undermine the corporate personality; at the same will help to deal with the misuse of the corporate personality. However, in this thesis it has been opted for a “Sledgehammer approach”.

A “back door approach” requires a high degree of judicial creativity in order to find a concept that suits the case and which can be justified. This degree of judicial creativity exists in common law tradition countries such as England but not in civil law tradition countries such as Panama. The “back door approach” is less combative yet it can be considered as being surrounded by uncertainty.

As a personal observation, a statutory rule is more compatible with the Panamanian legal framework. Panama is a civil law tradition country and as such it relies on statutory law. The motive behind the inclination for a “sledge hammer approach” is based on its practicality. A statute that directly deals with the corporate personality tends to be based on circumstances that may concur in any case and in any area of law. A statutory approach, however, has a drawback. A statute cannot cover every matter and legal loopholes will come to light with the application of the statutory rule.

Undeniably, a statute that directly allows the piercing of the corporate veil will be subject to criticism because it may be seen as something that will undermine the Panamanian corporate personality. This is a disadvantage that faces the “sledge hammer approach”. Nevertheless, in this thesis it is considered the more appropriate approach.

## Chapter Conclusion

The U.S. and England are the jurisdictions where corporate personality has been used to greater extent. England is the jurisdiction that pioneered the use of corporate personality as a device for commerce and the U.S. has used this instrument even more extensively. In fact, it can be considered that the modern corporate entity is originally Anglo-American. The piercing of the corporate veil is a phenomenon that derived from the existence and common use of the corporate personality by Anglo-American jurisdictions. Furthermore, whilst being the jurisdictions that pioneered the use of this entity, they were thus the first to experience the dilemma of whether or not to pierce the corporate veil. However, although the U.S. and England share a similar main rationale for piercing the corporate veil (the punishment and prevention of fraud), this subject has been addressed differently by both jurisdictions.

On the one hand, the English authorities have been reluctant to apply a remedy such as piercing the corporate veil. This position was defined in the case of *Salomon*. Since the decision over the case of *Salomon*, approaches based on concepts such as sham, agency and single economic unit have been proposed. However, no systematic approach to apply this remedy has derived from these concepts. The concept of sham has had more acceptance as a means to deal with corporate veil issues. However, in cases where it has been used to support an argument against the corporate personality, the decision has not been the piercing of the corporate veil but rather liability has been extended to the companies or defendants. The precedent of *Salomon* is solid and thus authorities have opted for alternatives that do not affect the integrity of the corporate personality in order to avoid conflict.

In this chapter, it has been pointed out that English authorities have adopted a different approach to deal with corporate personality issues. Notably, the fact that a specific approach has not been developed does not necessarily mean that the misuse of the corporate personality is allowed. In contemporary cases involving corporate personality issues, the Courts have tended to protect the integrity of the corporate

personality and justify liability on other grounds. In the cited case of *Chandler v Cape PLC*, the court established liability not by disregarding the existence of the corporate veil but by considering the existence of a duty of care towards an affected employee of a subsidiary.

In addition, English authorities have also relied on statutory rules to deal with corporate personality issues. However, statutory rules are not aimed at the corporate personality but instead at the parties responsible for its misuse. In this jurisdiction, the grounds on which an argument to pierce the corporate veil is likely to succeed are limited to cases involving circumstances that affect the interest of the state.

On the other hand, since the early days of the corporate personality, the U.S. has been more open to applying the piercing of the corporate veil; a factor that can be attributed to the plurality of internal jurisdictions that, along with other opinions, feeds the debate over topics such as the piercing of the corporate veil. The doctrines of instrumentality and alter ego, which are in essence the same, have been developed from the corporate veil debate. Both doctrines are aimed at making shareholders liable when it is proven that their excessive control over the corporate entity rendered it a mere instrument for fraudulent purposes.

The U.S doctrine to pierce the corporate veil has been the subject for criticism because there is not a concrete definition as to what can be considered as control and fraud. Moreover, the application of this doctrine is unpredictable and jurisprudence is full of vagueness. However, despite heavy criticism, the doctrines of instrumentality and alter ego are considered as the only systematic approach to deal with corporate veil issues. These doctrines present a set of circumstances that have to concur in order to ignore the corporate personality. The main trigger is the concurrence of wrongful and fraudulent behavior.

In the context of U.S. statutory law, there is no direct exception to the corporate personality. Undoubtedly, U.S. policy makers have gradually introduced exceptions to the corporate entity in areas of law in which public policies have been set in order to protect a public interest but these statutory exceptions are limited to a specific circumstance.

This chapter closes with a brief comparison that gave rise to the metaphors of “sledgehammer” and “backdoor”. The purpose of the former was to describe the active American position and of the latter the passive English position, in this context. I decided to briefly analyse which position would be the more appropriate for Panama to adopt because this will gradually introduce the reader to the core of this thesis. In addition, this chapter contributes to confirm one of the premises of this research; “the piercing of the corporate veil is a remedy that each jurisdiction adapts in accord to its internal needs.” Indeed, although the piercing of the corporate veil can be considered as an Anglo-American occurrence, the development of this subject has taken different paths in both jurisdictions.

## **CHAPTER III: The Doctrine of Piercing the Corporate Veil in Hispano-American Civil Law Jurisdictions; a comparison of the methods used by Spain and Latin American countries to deal with corporate veil issues**

The German academic Rudolf Serick suggested, in his work “*Rechtsform und Realität Juristischer Personen*” (Legal Form and Reality of Corporate Persons), to use the American doctrine of piercing the corporate veil in continental jurisdictions.<sup>274</sup> The work of Serick influenced certain aspects regarding the disregard of the legal entity in the civil law world. However, civil law jurisdictions have not copied wholesale American doctrine; rather, each civil law country has dealt with the abuses of the corporate veil in accordance with its own legal framework and needs, whilst following a similar objective to that of the American doctrine, i.e. the prevention and punishment of fraud.

This chapter discusses the piercing of the corporate veil in Spain and Latin America. Spain is a continental jurisdiction that follows the civil law tradition and moreover introduced this legal tradition to Latin America during the colonial period. Although Latin American countries are currently independent republics, the influence of Spanish civil law is still present and legal developments in Spain are to this day sometimes considered by Latin American jurisdictions. In regard piercing the corporate veil, Spain has developed an approach to deal with corporate veil issues, which consist in the use of domestic doctrines and concepts. Certainly, Latin American jurisdictions consider Spanish legal developments, but in the context of piercing the corporate veil Latin American countries have developed their own methods.

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<sup>274</sup> Serick, R. “*Rechtsform und Realität Juristischer Personen*”. Translated to Spanish by Brutau, P. *Aparencia y Realidad en las Sociedades Mercantiles*. Barcelona: Edit. Ariel;1958.

The objective of this chapter is to support my premise regarding prosperity and legal tradition as key factors when it comes to the development of an approach to deal with corporate veil issues. My objective is to demonstrate how traditional legal concepts have been used in this context by Latin American jurisdictions and the individuality each jurisdiction has when dealing with the corporate veil.

Before explaining the approach used by Spain, Argentina, Colombia, Chile and Brazil in dealing with corporate veil issues, I will briefly address two aspects that are imperative in the understanding of how corporate veil issues have been handled in the jurisdictions subject of study. These aspects are types of business associations and traditional legal concepts. As in the previous chapter, I will highlight differences among jurisdictions, which share the same legal tradition and have a historical connection, when it comes to piercing the corporate veil.

### 3.1 Types of Business Association

The Anglo-American joint stock corporation was the first type of business association to have the attributes of legal personality and shareholders' limited liability. Therefore, the American doctrine of piercing the corporate veil was originally aimed at dealing with the misuse of the corporation. However, the advantages of legal personality and limited liability have been gradually extended to other types of business associations such as the "Limited Liability Company". Therefore, among American academics whether the doctrine of piercing the corporate veil could be applied to limited liability companies has been a subject of interest.<sup>275</sup> In civil law jurisdictions, however, the action of disregarding the legal personality has not been aimed at one type of business association.

The forms of business associations that exist in the civil law jurisdictions under discussion in this thesis are classified under the Spanish heading *Sociedades Mercantiles* (in Portuguese "*Empresa Comerciais*"). This heading includes the

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<sup>275</sup> Limited Liability company is form of business association, which introduction in the U.S has been relatively recent. See, Huss, R. **Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age.** *University of Cincinnati Law Review.* (Volume 70) 2007. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1014432](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014432) [last visit may 30, 2013] at page 96-97. See also, Bainbridge, S. **Abolishing LLC Veil Piercing.** SSRN eLibrary. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=551724](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=551724) [last visit may 30, 2013]

*Sociedad Anónima* (in Portuguese “*Da sociedade anônima*”), which can be regarded as the equivalent to the Anglo-American joint stock corporation. Certainly, early cases involving corporate veil issues were based on the misuse of the *sociedad anónima*. However, the judiciary and academia did not limit the action of ignoring the corporate veil only to this type of business association.

Throughout the Twentieth Century, new types of business associations with the attributes of legal personality and shareholders’ limited liability have been introduced in Spain, Argentina, Colombia, Chile and Brazil. These forms of business associations are:

- *Sociedad de Responsabilidad Limitada* (SRL): a type of business association that requires less formality for its creation than does the *sociedad anónima*. The SRL has low capital requirements and its management is more flexible. The capital is not divided into shares but in *participaciones sociales*.
- *Sociedad Unipersonal*: a company that complies with all the legal requirements in order to exist but only one individual or legal entity owns a majority or all of the shares. Therefore it cannot be regarded as a company with a plurality of owners.
- *Empresa Unipersonal*: a type of commercial entity. The *empresa unipersonal* has a different legal personality to the owner, who has limited liability in regard to the acts made under the name of the business.
- *Sociedad por acciones simplificadas* (SAS): a derivation of the *sociedad anónima*, but it is more flexible regarding corporate governance aspects. One individual can create a SAS and be its sole shareholder and its legal representative. The SAS was created as an alternative to the *sociedad anónima*, which in some jurisdictions is subject to strict regulations. In some circumstances it is difficult for small entrepreneurs to comply with the requirements given in order to obtain the benefits of trading under the

corporate form. Therefore, the SAS was created to allow small entrepreneurs access to the benefits of legal personality and limited liability.

The rationale for the creation of these other types of business associations has been to satisfy the needs of small entrepreneurs and thus encourage investment. However, not all the jurisdictions addressed in this chapter have included all these types of business associations in their legal framework. These forms of business associations have been adopted by a jurisdiction in accord to its commercial needs.

The policy makers in the jurisdictions that have included some or all of these types of business associations have been aware of these associations' potential to be a device to practice fraudulent acts. Therefore, the application of an action to disregard the corporate veil has been extended to cases that may involve the misuse of the mentioned types of business association; a subject addressed more extensively throughout this chapter.

### 3.2 Traditional Legal Concepts

The use of traditional legal concepts has been one of the most common reactions against the misuse of the corporate veil in civil law jurisdictions. A civil law judge does not always have the faculty to use judicial creativity, as has the common law judge.<sup>276</sup> Therefore, in deciding early cases which involved a misuse of the corporate veil, civil law judges sought principles and legal concepts contained in positive law in order to support a decision to pierce the corporate veil. It is important to add that although Spain, Argentina, Colombia, Chile and Brazil are different legal systems, they have been built on similar legal principles and concepts. Consequently, the legal concepts cited to deal with corporate veil issues are the same. The most used traditional legal concepts in corporate entity issues are:

- *Fraude a la ley*: (Fraud of the Law): the use of alternative legal means to achieve a result intended by another law or laws to be prohibited.<sup>277</sup> For

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<sup>276</sup> See, Perdomo, R. & Marryman, j. *Supra note* 17. At page 48-49

<sup>277</sup> Becerra, F. *Diccionario de Terminología Jurídica Mexicana (español- Inglés)*. Mexico: Escuela Libre de Derecho; 1999.

example, an individual who is restricted from contracting with the state due to administrative faults avoids this restriction by using a legally incorporated company to contract with the state.

- *Simulación*: this is a concept based on the use of legal means to avoid obligations. In civil law there are two types of simulated acts, *simulación absoluta* and *simulación relativa*. *Simulación absoluta* makes reference to an act, which assumes an appearance not corresponding to reality, and is usually the result of two or more persons who attempt to accomplish an unlawful purpose. For example X transfers his property to Y. In reality X continues to own the property but by simulating the transfer X avoid the enforcement of Z's credit over X's property. *Simulación relativa* refers to an act that is made to conceal the true character of the purpose sought by the parties and therefore once discovered the true act or transaction is made retroactively effective for all purposes.<sup>278</sup> For example, X sells his property to Y for £100,000, but in the contract it is stated that the price is £50,000. The purpose in concealing the original price is to avoid taxation.
- *Abuso del derecho*: (Abuse of rights): intentional exercise of rights by a person that causes harm to another with no benefit to the person, and which entails an indemnity obligation, provided it is proven that such right was exercised for the sole purpose of causing damage or harming the other person.<sup>279</sup> For example, individuals have the right to associate and use the benefits of the corporate personality. However, if the right to use and benefit from the use of the corporate form is used to defraud third parties, there is an abuse.

Besides *fraude a la ley*, *simulación* and *abuso del derecho* there are also legal devices such as the *Acción Pauliana*, which has been used to deal with corporate veil issues. The *acción pauliana* is a legal remedy to enforce contractual obligations. This remedy is applied when one of the contracting parties performs other legal acts in

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<sup>278</sup> *Idem*  
<sup>279</sup> *Idem*

order to avoid his obligations to the other party. The affected party may request this remedy in order to nullify the acts made by the other party. Thus, enforce the contract.

These concepts and principles have been present in civil law tradition and have been an auxiliary means to deal with corporate veil issues. Moreover, some of these concepts have become the basis of current exceptions to the corporate personality in some civil law jurisdictions. Based on this fact it cannot be asserted that the American doctrine of piercing the corporate veil has been adopted or copied by Hispano-American jurisdictions. Indeed, it can be argued that the Hispano-American approach to deal with corporate veil issues has a degree of originality.

The ways in which legal concepts and legal devices have been used vary among civil law jurisdictions. As has been stated in the previous chapters, the piercing of the corporate veil is a subject developed individually by each jurisdiction. Spanish civil law has certainly influenced Latin American countries subject of study in this thesis (except Brazil). However, Latin American countries that have dealt with corporate veil issues have done so in a way different to that of Spain.

### **3.3 The Spanish Method to Deal with the Misuse of the Corporate Veil**

The Spanish approach to deal with corporate veil issues has been developed in two stages; the first stage started with the *doctrina de terceros*, which functioned in a different way to the American piercing of the corporate veil yet achieved the same result; the second stage started in the 1980s with the introduction of the Spanish doctrine of *levantamiento del velo*.<sup>280</sup> The *levantamiento el velo* is Spanish for *lifting the corporate veil*. In this section, I will address this concept by its Spanish name.

The reason to include Spain in this thesis is not only its historical connection with my case study Panama and other Latin American jurisdictions, but also the peculiar development of piercing the corporate veil in this jurisdiction. In order to explain the Spanish approach to deal with the misuse of the corporate veil, I shall first address the

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<sup>280</sup> See, Perez, R. **Una Vision Dual de la Doctrina del Levantamiento del Velo de la Persona Juridica**. *Revista del Instituto de la Judicatura Federal* (No 25) 2008. At page 170

*doctrina de terceros*. I will address the concept and how this doctrine developed into the *levantamiento del velo*. Following this, the current situation of the Spanish *levantamiento del velo* will be explained.

### 3.3.1 Doctrina de Terceros

The *doctrina de terceros* is an early approach used by the Spanish judiciary to deal with the misuse of the corporation's legal personality.<sup>281</sup> This doctrine is based on the fact that the corporation and the shareholders are third parties in regard to each other's acts; for example, the corporation is a legal person with capacity to contract. Contracts signed under the name of the corporation only make the corporation, and not the shareholders, liable. In the same way, the corporation is a third party in regard to the acts and obligations of an individual or group of shareholders. Under this doctrine, issues regarding the misuse of the corporation's attributes are not solved by disregarding the corporation's legal personality but instead liability is extended to the shareholders (or the corporation). By losing the status of third party in regard to the acts of the other, liability is extended. Based on the fact that the integrity of the corporation's legal personality is respected, I consider the Spanish *doctrina de tercero* differs from the piercing of the corporate veil.

An early case involving the application of the *doctrina de terceros* is the precedent established in the *Sentencia de 7 de junio de 1927*.<sup>282</sup> In this case the defendant was obligated to pay a compensation derived from an arbitral judgment. However, after the arbitral judgment was issued, the defendant created a company and transferred his assets. The Spanish *Tribunal Supremo*<sup>283</sup> considered the time on which the transfer of assets was made as a factor to determine the intention of the defendant. The fact the defendant constituted the company and the assets were transferred after the issue of the award made the *Tribunal Supremo* consider the conduct of the defendant as elusive. However, the *Tribunal Supremo* decided not to ignore the company's legal

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<sup>281</sup> See, Boldo, C. *Levantamiento del Velo Corporativo y Persona Juridica en el Derecho Privado Español*. 4th Edition. Navarra: Editorial Arazandi; 2006. At page 175

<sup>282</sup> This precedent was cited by the author Carmen Boldo. *Idem*. At page 177

<sup>283</sup> The Spanish *Tribunal Supremo* is the highest court in Spain for all matters not pertaining to the Spanish Constitution. The *Tribunal Supremo* meets in the *Palacio and Convento de las Salesas Reales* in Madrid. The *Tribunal Supremo* consists of a president and an indeterminate number of magistrates appointed to the five chambers of the court. See, [http://www.poderjudicial.es/cgpj/es/Poder\\_Judicial/Tribunal\\_Supremo?Template=cgpj/ts/principal.htm](http://www.poderjudicial.es/cgpj/es/Poder_Judicial/Tribunal_Supremo?Template=cgpj/ts/principal.htm)

personality; instead, the effects of the arbitral judgment were extended to the corporation's assets.<sup>284</sup> Another example regarding the application of the *doctrina de terceros* is the *Sentencia de 26 de enero de 1952*.<sup>285</sup> In this case the defendant was the owner of properties that were for let. In the contract signed between the landlord and the tenants, there was a clause in which the tenants had the right to re-occupy the flats after construction work. At some point the defendant embarked upon a project to refurbish the flats, but did not want the tenants back. Thus, the defendant decided to create a company and transfer the properties to the company. The court considered that the properties were transferred to a corporate entity used by the defendants as a means to avoid the contractual obligation. In this case, the company lost its status of third party due to bad faith in the transaction between the landlord and the company. Thus, the tenants were allowed to return to the flats.

The *doctrina de tercero* did not only look to the actions but also to the fact that the corporation complied with the conditions established in the law. In the *Sentencia de 8 de octubre de 1929*,<sup>286</sup> the *Tribunal Supremo* denied the condition of third party to a corporation whose Memorandum of Association fell under the scope of the concept of *simulación*. The lack of legal ground with which to support the corporate personality made the tribunal consider this as invalid.

This doctrine became the primary tool for dealing with issues involving the corporate veil. However, with the use of the *doctrina de terceros* becoming more common, the need for a more complete approach to deal with corporate personality issues was becoming evident.

In the *Sentencia de 8 de enero de 1980*,<sup>287</sup> the *Tribunal Supremo* did not disregard the corporation's legal personality, but nevertheless established the foundation for its later application. In this case, the company "PROTUCASA" was constituted to carry out the development of a residential project. Some of the shareholders of

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<sup>284</sup> The decision of the Spanish court on this case, I consider, is similar to the English approach in the cases *Gilford Motors v Horne* and *Jones v Lipman* (previously cited in the second chapter). In both cases the liability of the shareholders was extended to the company, losing the latter its "**status of third party in regard of the shareholder's obligations**".

<sup>285</sup> STS de 26 de enero de 1952 (RJ 1952, 478)

<sup>286</sup> This precedent was cited by the author Carmen Boldo. *Supra note* 281. At page 177

<sup>287</sup> STS de 8 de enero de 1980 (RJ 1980,21)

PROTUCASA bought properties in the project. However, irregularities arose and a group of tenants, who claimed the compliance of contract clauses, sued PROTUCASA. Nonetheless, PROTUCASA argued that the contract was not valid because some of the complaining tenants were shareholders of PROTUCASA. By contracting with themselves they undermined the corporation's status of legal personality. In this case the *Tribunal Supremo* decided to consider not just the form but also the substance of the relationship in order to determine the role of the claimants who were members of the defendant company. In the end the court held that the claimants' relationship with PROTUCASA did not affect the integrity of the corporation's legal personality. Shareholders and the company have different legal personality, thus, the contract was valid. In this case the court did not regard the corporate entity as a third party, but regarded the parties behind the veil of incorporation and analysed the intention of the parties.

The *doctrina de terceros*, it could be considered, respects the integrity of the corporate personality. However, there are circumstances such as the case PROTUCASA in which is not possible to deal with the issue by the extension of liability. In the cited case the court has to evaluate whether the corporate personality fulfill the requirements to be considered a legal person. Certainly, it was not a case about piercing of the corporate veil, but involved a debate about the existence of the corporate personality. The *doctrina de terceros* is effective to deal with liability derived from contractual obligations. However, there are circumstances that require a deeper reasoning about whether or not to preserve the existence of the corporate personality, as the case decided by the *sentencia de 28 de mayo de 1984*.

### 3.3.2 El Levantamiento del Velo y Persona Juridica

The *Sentencia de 28 de mayo de 1984*<sup>288</sup> is the first Spanish precedent in which the *levantamiento del velo* is directly used as a remedy to deal with corporate personality issues.<sup>289</sup> This case was based on a compensation claim. The company *Uto Ibérica S.A* owned a number of apartments in “*la Palma Mallorca*” that were damaged by water from a broken pipe in the water supply network. Due to the damage caused by

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<sup>288</sup> STS de 28 de mayo de 1984 (RJ 1984, 2800)

<sup>289</sup> See, Boldo, C. *Supra note* 281. At page 186

the water, the apartments were not available for rent during the summer. Consequently, *Uto Ibérica S.A* suffered a financial loss.

In order to be compensated for financial loss, *Uto Ibérica S.A* started proceedings against the Bureau *de la Palma* in April 1978. Legal actions were taken against the Bureau since water supply was one of the services provided by the Bureau. However, previous to the events of the case, the Bureau created a company called “*Empresa Municipal de Aguas y Alcantarillado*” (EMAYA) for administering and maintaining the water supply network. The objective was to make the Bureau’s administration more efficient.

With regard *Uto Ibérica S.A*’s claim the Bureau denied any liability on grounds that EMAYA was in charge of the water supply network. Therefore, EMAYA was held liable. The argument made by the Bureau did not make *Uto Ibérica S.A* desist from its actions against the the Bureau. Instead, besides maintaining its claim against the Bureau, it also started proceedings against EMAYA in 1979.

The First Instance Court dismissed both claims. However, the *Audiencia Territorial*<sup>290</sup> (Provincial Tribunal) partly supported one claim. The Bureau was absolved but the claim against EMAYA was maintained. However, EMAYA presented a “*recurso de casación*”<sup>291</sup> in which it was argued that legal action against it was not valid because it was subject to an expiration date. The actions against EMAYA started almost one year after the actions against the Bureau. This type of proceedings is subject to an expiration date in order to avoid saturation of the Courts. EMAYA argued that the actions against the Bureau did not interrupt the expiration date because the Bureau and EMAYA are separate legal entities. In other words, if a legal action was admitted against EMAYA, it would be a whole new proceeding regarding the same case.

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<sup>290</sup> *Audiencia Territorial* is a second instance court. It has competence mainly over apelations in civil and administratives matters. See,

[http://www.poderjudicial.es/cgpj/es/Poder\\_Judicial/Tribunales\\_Superiores\\_de\\_Justicia](http://www.poderjudicial.es/cgpj/es/Poder_Judicial/Tribunales_Superiores_de_Justicia)

<sup>291</sup> It is a legal resource that consists on the revision of a final judgement. It is exceptional and requires a strong justification in order to be accepted. This resource focuses on the form and substance of the judgement. If errors of form or substance are found, the judgment is reconsidered. Caballenas, G. **Diccionario Juridico Elemental**. Heliasta. Buenos Aires. 2009

In order to make a decision, the *Tribunal Supremo* decided to apply *el levantamiento del velo corporativo*. By lifting the corporate veil the *Tribunal Supremo* found a unity of interest and a similar administration (The Mayor was the administrator and member of the board in the company). The existence of a common administration and a unity of interest made the *Tribunal Supremo* consider the Bureau and EMAYA as one similar entity. Furthermore, due to its consideration, the expiration was interrupted. Therefore, *recurso de casación* was dismissed and EMAYA and the Bureau were regarded as the same entity in relation to proceedings. The Court decided that EMAYA was liable and had to pay compensation. It is important to add that the veil was lifted in order to determine the link between the bureau and EMAYA for procedural purposes, not to make the Bureau liable together with EMAYA. In the judgment, only EMAYA had to pay compensation to the plaintiff.

Notably, this was the first time the legal personality was directly ignored in Spain.<sup>292</sup> The existence of a unity of interest and a common administration were the basis of the court's analysis, but the court analysis was also reinforced through existent legal concepts applied to the case. Definitely, due to a lack of guiding principles or rules, the *Tribunal Supremo* justified ignoring the corporate personality on values contained in the Spanish Constitution<sup>293</sup> and legal concepts contained in the Spanish *Código Civil*<sup>294</sup>. These are:

- Conflict between legal certainty and justice (article 1º.1 and 9º.3, *constitucion*)
- Equity (article 3º.2, *Código Civil*)

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<sup>292</sup> The following is an abstract containing the argument which the Spanish *Tribunal Supremo* based the application of the *levantamiento del velo*:

“...desde el punto de vista civil y mercantil, la más autorizada doctrina, en el conflicto entre **seguridad jurídica y justicia (legal certainty and justice)**, valores hoy consagrados en la Constitución, se ha decidido prudencialmente y según los casos y circunstancias, por **aplicar por vía de equidad (apply equity)** y **acogimiento del principio de buena fe (principle of good faith)**, la tesis y práctica de penetrar en el substractum personal de las entidades o sociedades a las que la ley confiere personalidad jurídica propia, con el fin de **evitar que al socaire de esta ficción o forma legal se pueda perjudicar ya intereses privados o públicos o bien ser utilizada como camino de fraude (avoid the use of this legal fiction in a way it affects public and private interest, or is an instrument to practice fraud)**, admitiéndose la posibilidad de que los jueces puedan penetrar en el interior de esas personas cuando sea preciso para evitar **el abuso de esa independencia en daño o de los demás o contra intereses de los socios, es decir, de un mal uso de su personalidad, de un ejercicio antisocial de su derecho (abuse and misuse of rights)**....”

<sup>293</sup> Boletín Oficial del Estado el 29 de diciembre de 1978, *Constitucion Nacional de España*

<sup>294</sup> Real decreto de 24 de Julio de 1889, *Código Civil Español*. 2009 edition.

- Fraud ( article 6.4, *Codigo Civil*) and *perjuicio de intereses*
- Buena fe y Abuso del Derecho* (article 7.2, *Codigo Civil*)

Before explaining how the current *levantamiento del velo* has been developed since the commented case, I will briefly explain each of the concepts on which the Spanish authorities justified the decision over the commented case.

### 3.3.2.1 Conflict between legal certainty and justice

Legal certainty is a fundamental pillar of any legal system. Legal certainty can be defined as a value that requires authorities to make decisions in accord with legal rules in order to prevent arbitrary use of power. The prevention of arbitrariness and the adherence to law generates certainty because authorities' behavior becomes predictable. However, legal certainty is just one value that needs to be complemented with other concepts such as justice. Justice can be defined as a force that preserves freedom and equality. Moreover, it can be considered the rationale of the law's existence. In Spain, the concepts of legal certainty and justice are contained in the constitution and the State has the duty to preserve these values. However, there are circumstances in which both values conflict, such as the previous commented case.

In *Sentencia de 28 de mayo de 1984* the *Tribunal Supremo* justified the prevalence of justice over legal certainty and proceeded to set aside the corporation's legal personality. In the wording of the sentence by the *Tribunal Supremo*, an appraisal of the conflict between legal certainty and justice is made and it is decided that justice prevails over legal certainty: "in this conflict between legal certainty and justice, values protected by the constitution, it has been decided to set aside the corporate personality..."<sup>295</sup> As a rule, the corporate personality contained in company law which has no exception generates a tendency to preserve it; indeed, a predictable outcome. However, the fact that the court decided to ignore the corporate personality shows a clear inclination to achieve justice over certainty.

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<sup>295</sup> "*en conflicto de entre seguridad juridica y justicia, valores hoy consagrados en la constitucion (1º.1 y 9º.3) se ha decidido prudencialmente penetrar el substratum personal de las entidades a las que la ley confiere personalidad juridical propia...*"

### 3.3.2.2 Equity

The concept of equity makes reference to two situations. Firstly, equity makes reference to a set of ethical principles that guide application of equity. Secondly, equity is the method used by judges to solve cases based on its reasoning when the strict application of legislation may produce an evident injustice.

The concept of “equity” was introduced in Spain with reforms to the Spanish *Código Civil* in 1974.<sup>296</sup> However, equity in Spanish legislation has not been based on philosophy and ethics; rather, the Spanish legislator made an attempt at developing a coherent and compatible concept of equity with Spanish legal framework. In the article 3.2° of the *Título Preliminar* of the Spanish *Código Civil* it is stated, “equity must be taken into account in applying rules, but the resolutions of the Courts may only be based exclusively on equity when the law expressly allows this.” The sentences that compose the cited article present two situations in which the concept of equity is present.

- **Equity must be taken into account in applying rules.** This sentence refers to the use of equity as a tool to interpret the law. In this context equity is used to provide an appropriate solution when a rule creates doubts regarding its interpretation; in other words, a rule that is supposed to regulate a determined circumstance seems to be inadequate. This mode of equity has not been widely accepted by the Spanish Tribunals, which have a preference for the second method.
- **A judgment can be based on equity as long as the law expressly allows it.** This notion of equity has been more accepted by the Spanish judiciary. I believe that this is so as it better adapts to the nature of the Spanish civil law system. Some situations in which the Spanish legislation allows judges to exercise equitable discretion are: “*prudente arbitrio*” to take measures to protect assets (*artículo 181 Código Civil*), “*lo que corresponda*” for the

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<sup>296</sup> See, Boldo, C. *Supra note* 281. At page 202

administration of common property (*artículo 398 del Código Civil*), to moderate the effects of liability derived from negligence (*artículo 1103 del Código Civil*).

The two sentences that compose part of the wording of the Article 3.2° are classified by the Spanish author Carmen Boldo as *equidad como medio interpretativo* (equity as a tool to interpret law) and *equidad como fundamento de las resoluciones de los Tribunales* (equity as ground of judgment).<sup>297</sup>

The *Sentencia de 28 de mayo de 1984* was not based on equity.<sup>298</sup> There is no statute in Spanish law that allows the judge to disregard the corporation's legal personality based on equity. However, the *Tribunal Supremo* did use equity as a tool to interpret the law. Although this mode of equity has not been widely accepted, it did provide a solution for the case at hand. In the *Sentencia de 28 de mayo de 1984*, the preservation of the corporate veil would have allowed the prescription of proceedings and the plaintiff would therefore not have recovered any compensation. I regard that the *Tribunal Supremo* summoned equity in this case in order to solve the conflict between legal certainty and justice.

### 3.3.2.3 Fraud and *Perjuicio de Intereses*

In Anglo-American jurisdictions as well as in civil law jurisdictions, the concept of fraud is the rationale on which the approach to deal with corporate veil issues has been built. In the *Sentencia de 28 de mayo de 1984* the Spanish *Tribunal Supremo* summoned the concept of *fraude a la ley* contained in the article 6.4 in the *Título Preliminar* of the *Código Civil* which provides that “Acts performed pursuant to the text of a legal rule, which pursue a result forbidden by the legal system or contrary thereto shall be considered to be in fraud of the law and shall not prevent the due application of the rule which they purported to avoid”.<sup>299</sup>

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<sup>297</sup> *Idem*. At page 204

<sup>298</sup> *Supra* note 288

<sup>299</sup> “*Los actos realizados al amparo del texto de una norma que persigan un resultado prohibido por el ordenamiento jurídico, o contrario a él, se considerarán ejecutados en fraude de ley y no impedirán la debida aplicación de la norma que se hubiere tratado de eludir.*”

From the study of the facts of the case decided by the cited *Sentencia*, there was no direct allegation of fraud. Certainly, this has been the subject of debate among the Spanish academia.<sup>300</sup> However, although there was no fraud, in this precedent the court considered that the purpose of emphasising the concept of fraud is to demonstrate that the use of the corporate personality can be seen to contradict its original purpose.<sup>301</sup> In later Spanish cases dealing with the *levantamiento del velo*, the concept of fraud is more extensively developed.

#### 3.3.2.4 Good Faith and *Abuso del Derecho*

The principle of good faith makes reference to the duty each individual has to act in a manner that is in accordance with morality, honesty and other social values. In a legal context, good faith can be considered as a concept that supplements the law by establishing a limit in the use of rights. In other words, a person can enjoy their rights as long as they are not used in bad faith. The use of right(s) in bad faith may produce the invalidity of the right(s), the void of acts made under the use of this right(s) and the payment of compensation if any harm has been produced.

In the *Titulo Preliminar* of the Spanish *Código Civil* is provided in the article 7.1: “rights must be exercised in accordance with the requirements of good faith”. Good faith is a general concept and it may be too vague if it is applied by itself to deal with corporate veil issues. Therefore, the Spanish judiciary opted to summon the concept of good faith together with the concept of *abuso del derecho*, which makes reference to the use of rights in an irregular manner to the point it produces harm or loss to third parties.<sup>302</sup>

How rights are to be used is addressed in the article 7.2 of *Titulo Preliminar* in the Spanish *Código Civil*: “the law does not support abuse of rights or illicit exercise thereof. Any act or omission which, as a result of the author’s intention, its purpose or the circumstances in which it is performed manifestly exceeds the normal limits to exercise a right, with damage to a third party, shall give rise to the corresponding compensation and the adoption of judicial or administrative measures preventing

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<sup>300</sup> See, Laporta, J. *Comentarios al Código Civil y las Compilaciones Forales*. Tomo I. Madrid: Editorial Temis; 1992. At page 852

<sup>301</sup> See, Boldo, C. *Supra note* 281. At page 219

<sup>302</sup> See, *Idem*. At page 233-234

persistence in such abuse.” Based on this rule, three aspects are considered in determining whether there has been *abuso del derecho*. These are as follows: intention of the person, objective and the circumstances in which the right is used. Certainly, the parameters established to determine *abuso del derecho* strengthen an argument to pierce the corporate veil based on good faith.

In the case resolved by the *Sentencia de 28 de mayo de 1984*, however, the elements required for an *abuso del derecho* were not present. It can be said that *abuso del derecho* was used in a vague manner. The author Carmen Boldo in her study about *el levantamiento del velo*, argues that in this context the Spanish courts have used the concept of *abuso del derecho* without any reasoning or deep justification for its use.<sup>303</sup>

### 3.3.3 The Current Doctrine of *Levantamiento del Velo Corporativo*

Since the precedent established in the *Sentencia de 28 de mayo de 1984*, the Spanish approach to deal with corporate veil issues has been developed through legislation and doctrine. The development of legislation is the result of the criticism made by a sector of the Spanish academia against the standard established in the *Sentencia de 28 de mayo de 1984*.<sup>304</sup> It is considered that *fraude a la ley*, *buena fe*, *abuso del derecho* and *equidad* are vague concepts, whose application may hinder legal certainty and produce arbitrary judgments.<sup>305</sup> However, despite this criticism, the jurisprudence following the *Sentencia de 28 de mayo de 1984* have contributed to the development of legislation that deals with corporate personality issues in Spain. Currently, legislations and doctrines can be considered complementary to each other when dealing with corporate personality issues in Spain.

The areas where the Spanish *levantamiento del velo* can be considered to have been more active are: *unipersonalidad sobrevenida*, corporate groups, *infracapitalización nominal* and avoidance of legal rules and contractual obligations.

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<sup>303</sup> See, *Idem*. At page 247

<sup>304</sup> See, Hurtado, J. *La Doctrina del Levantamiento del Velo Societario en España e Hispanoamérica*. España: Atelier; 2008. At page 36

<sup>305</sup> *Ibid*

### 3.3.3.1 Unipersonalidad Sobrevenida

The commingling of assets, siphoning of assets, and excessive control by one individual or a legal entity over a company, have been issues that Spanish jurisprudence has addressed in ample extent in the context of *Sociedades Unipersonales*.<sup>306</sup>

The previous regulation for *sociedad de responsabilidad limitada* and *sociedad anónima* did not establish nor regulate the possibility of creating a *sociedad unipersonal*. Therefore, due to the lack of restriction, individuals and legal entities could own a majority of shares in a company to the point it could not be regarded as a company with plurality of owners. This phenomenon was addressed as *unipersonalidad sobrevenida*.

The *levantamiento del velo* has been a method for dealing with the confusion of assets derived from *unipersonalidad sobrevenida*. An example is the *Sentencia del Tribunal Supremo de 3 de junio de 1991*.<sup>307</sup> In that case a company called “*Las Llantas S.A*” owned the shares of another company called “*Arboleda S.A*”. An individual representing “*Las Llantas, S.A*” sold a part of a property owned by “*Arboleda S.A*” to the claimant in order to engage in the development of a residential project. However, there was an issue that led the claimant to sue both companies. *Arboleda S.A* claimed that it was not part of the contract. Therefore it was not subject to proceedings. Moreover, it requested the rescission of the contract because the properties sold to the claimant by *Llantas S.A* did not belong to this company. However, the *Tribunal Supremo* considered that the preservation of the legal personality and separation assets would produce a loss for the claimant. Therefore, based on the fact that *Las Llantas S.A* had used the assets of *Arboleda S.A* as if they were their own, in addition to the fact that the former owned the shares of the latter and there was an intention to avoid obligation, the Tribunal considered both companies to be liable for the obligation towards the claimant.

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<sup>306</sup> See, Boldo, C. *Supra note* 281. At page 273

<sup>307</sup> *STS de 3 junio de 1991* (RJ 1991,4411)

The regulation of the phenomenon of *unipersonalidad sobrevenida* was the initiative taken to diminish fraudulent practices in this context. The *Ley 2/1995 de 23 de marzo* reformed the regulation for *Sociedades de Responsabilidad Limitada*, and introduced the *Sociedad Unipersonal* in Spain. In this regulation, the *sociedad unipersonal* is defined as the company created by an individual or legal person or a company whose shares were bought by one member from the other members.<sup>308</sup> The formal regulation of the *sociedad unipersonal* and measures to prevent its abuse created an environment of certainty that did not previously exist.

### 3.3.3.2 Corporate Groups

The phenomenon of corporate groups is quite recent in Spanish positive law. The *Ley del Mercado de Valores (Ley 24/1988, de 28 de julio)* is the first body of law that defines the concept of corporate groups in Spanish legislation as a conglomerate of companies that act under the same direction and unity of interest.<sup>309</sup> Regulations regarding consumers' protection, banks, accountability standards and the code of commerce address certain aspects of corporate groups. However, only certain statutes present a rule that establishes excessive control as a trigger for the disregard of the legal personality in the context of corporate groups. An example is the Spanish competition law (*Ley 16/1989, de 17 de julio*), which in its Article 8 ignores the legal personality of the companies' part of a group, in order to extend the liabilities of the controlled company to the controller company.

Spanish courts have used the doctrine of *levantamiento del velo* as an alternative to positive law when dealing with the fraudulent use of the group structure. In this context, the application of this doctrine has been based on the concept of group. The functions of a corporate group are based on a unity of interest and command. In this unit, each company is a different legal person with its own rights and liabilities. However, when the legal entity has been used to evade obligations the veil must be lifted for the group to answer as a whole. In the *sentencia de Tribunal Supremo de*

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<sup>308</sup> The *Sociedad Unipersonal* is defined and regulated in the article 125, *Capítulo XI* about *Sociedad de Unipersonal de Responsabilidad Limitada*. Contained in the *Ley 2/1995 de 23 de marzo sobre Sociedades de Responsabilidad Limitada*.

<sup>309</sup> The *Ley 24/1988* was modified by the law 13/1992. The definition of the corporate group and the factors that must concur to consider the existence of a group are currently established in the article 42 of the Spanish *Código de Comercio*.

27 octubre de 2004,<sup>310</sup> the Tribunal emphasised that the use of a device such as the corporate personality must not be used as a means to achieve fraud; in this case, the company *Sisbarna* had the majority of shares of *Siscomp*. Both companies shared the same domicile and *Sibarna* established the policies followed by *Siscomp*. However, the accountability of both companies was not clear and created confusion. *Siscomp* could not comply with its obligation. Therefore, the Tribunal ignored the separate corporate personality and regarded the companies as one unit since *Sisbarna* created *Siscomp* as a company to avoid liabilities and the payment of debts.

The doctrine of *levantamiento del velo* has definitely been useful to deal with the concept of corporate groups in Spain. Nonetheless, this has not been widely applied in private law cases involving corporate groups. Rather, this doctrine has been applied to a greater extent in cases dealing with corporate groups in the context of labour law.<sup>311</sup>

#### 3.3.3.2.1 The *levantamiento del velo* and corporate groups in Spanish Labour law

The early labour law cases involving a group of companies were based on the issue of identifying the employer. The group structure allows the creation of a network of companies that in some cases is used to evade obligations the employer has to the employee(s). The Spanish judiciary in the period previous to the introduction of the *levantamiento del velo* addressed this issue initially through the *Principio de Unidad de Empresa* (single economic unit). An example is the *Sentencia del Tribunal Central de Trabajo de 15 de octubre de 1982*,<sup>312</sup> in which the Labour Court recognised the separate existence of two companies. However, it also held that the concept of legal personality could not be used to avoid obligations towards the employees. Both companies act under a common direction and aim to achieve a similar goal. Thus, if both companies act as a unit, both should answer for their debts as a unit.

The doctrine of *levantamiento del velo* was applied later in this context but constructed on a similar objective to that of a single economic unit, to regard the group as a unit. Spanish labour case law has gradually built grounds on which the

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<sup>310</sup> *Sentencia de Tribunal Supremo de 27 octubre de 2004* (RJ 2004, 7042)

<sup>311</sup> See, Yaguez, A. *La Doctrina del Levantamiento del Velo en la Jurisprudencia*. 4th edition. Navarra: Civitas; 1997. At page 255

<sup>312</sup> *Sentencia del Tribunal Central de Trabajo de 15 de octubre de 1982* (RTCT 1982, 5878)

joint liability of a group of companies can be justified. In the *Sentencia de la Sala Sexta del Tribunal Supremo de 30 de Junio de 1993*,<sup>313</sup> the court mentioned the following:

- a- Joint liability is imputed to a corporate group that presents vertical domination, unified governance and a personal and economic relationship. (*Sentencia de 24 de Julio de 1989* (RJ 1989, 5908))
- b- To consider joint liability in regard of employer obligations, it is necessary for the members of the group to have not only an economic relationship but also share the payroll. (*Sentencia de 22 de enero de 1990* (RJ 1990, 180))
- c- Besides unified governance, joint liability requires the concurrence of commingling of assets, no determination for which company the employees work, improper use and abuse of the corporation's legal personality to the point it has a negative effect on the employees. (*Sentencia de 30 de enero de 1990* (RJ 1990, 233))
- d- In a group, the concurrence of a nexus or connection must be based on special characteristics. Firstly, the unified functioning of the group must be as it is described in the *SS de 6 de mayo de 1981* (RJ 1981, 2103) and *SS de 8 de octubre de 1987* (RJ 1987, 6973). Secondly, employee performance in the different companies in the group, without defining who is the employer, must be based as described in *SS de 11 de diciembre de 1985* (RJ 1985, 6094), *SS de 3 de marzo de 1987* (RJ 1987, 1321), *SS 8 de junio de 1988* (RJ 1988, 5256), *SS 12 de Julio de 1988* (RJ 1988, 5802) and *Sentecia de 3 de mayo de 1990* (RJ 1990, 3946).
- e- To declare joint liability the concurrence of factors such as confusion of payroll, confusion of assets and the use of a company as a façade are required. (*Sentencia de 19 de noviembre de 1990*)

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<sup>313</sup> *Sentencia de la Sala Sexta del Tribunal Supremo de 30 de Junio de 1993* (RJ 1993,4939)

- f- Employees' performance in different companies in the group is not an illicit act aimed at hiding the real employer. It is a practice based on the organization of the enterprise. This practice will be licit as long as the employee's rights are not affected. (*Sentencia de 26 de noviembre de 1990* (RJ 1990, 8605))

The *levantamiento del velo* has been relevant in labour law cases involving corporate groups. The fact that guidance for the application of this remedy has been established in case law evidences a tendency of the Spanish judiciary to prevent the abuses against employees through the use of the group structure.

### 3.3.3.3 *Infracapitalisacion Nominal*

The concept of undercapitalisation is divided into two: *infracapitalisacion material* and *infracapitalisacion nominal*.<sup>314</sup> *Infracapitalisacion material* makes reference to a company with no capital or assets to perform due to shareholders not paying their share or due to a lack of financing.<sup>315</sup> *Infracapitalisacion nominal*, on the other hand, makes reference to a company that has enough capital to perform; however, the capital does not derive from shareholders' contributions and instead is rendered from loans made by the shareholders to the company.<sup>316</sup>

*Infracapitalisacion material*, on the one hand, I personally consider does not create corporate veil issues. Spanish company law establishes a minimum capital for *sociedades anónimas* and *sociedades de responsabilidad limitada*.<sup>317</sup> The payment of capital is a formality that has to be fulfilled in order for the company to come into existence. If the capital is not paid up the company is invalid. In the case of individual shareholders, if he/she/it do not pay the value of the share, rights cannot be enforced. *Infracapitalisacion material* is an issue that affects companies' existence and shareholders' rights. If a company is invalid due to the non-payment of the required capital this cannot be used to engage in wrongful practices.

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<sup>314</sup> See, Martorell, R. *La Doctrina de la Infracapitalizacion: Aproximacion Conceptual a la Infracapitalizacion de las Sociedades*. *Revista de Derecho Societario*. 2004. Available at [www.aedssite.com/revista/pdfs/aeds\\_revista\\_7\\_10.doc](http://www.aedssite.com/revista/pdfs/aeds_revista_7_10.doc) [last visit may 30, 2013] At page 178

<sup>315</sup> See, *Idem*. At page 179

<sup>316</sup> *Ibid*

<sup>317</sup> The *Ley 2/1995 de sociedades de responsabilidad limitada* in the article 4 establishes minimum capital € 3,000. The *Real Decreto Legislativo 1564/1989, de 22 diciembre. Texto refundido de la ley de Sociedades Anonimas* establishes in the article 4 the minimum capital €60,000.

*Infracapitalisacion nominal*, on the other hand, is used for fraudulent purposes in some cases. By lending capital to the company, shareholders gain the status of creditors. Moreover, shareholders' credit may have preference over other creditors; a situation that may leave the company with not enough assets to pay its debts after shareholders recover their credit.

In Spain the issue involving *infracapitalisacion nominal* has been solved through the enactment of the *Ley Concursal de 2003* (insolvency law).<sup>318</sup> In Articles 92 and 93 of this law, it is established that the debts of the company in regard to shareholders loans will be paid after all the creditors have been paid. The law in these articles established that a creditor who has a relationship with the debtor in the form of five percent of the company's shares, would lose his preference over the company's assets.

The *Ley concursal de 2003*, however, partially solves the issue of *infracapitalisacion nominal*. The *ley concursal* has a gap in cases in which the shareholder has property rights over the assets that form the debtor's assets. Thus, Spanish courts have opted to deal with this issue by using the doctrine of *levantamiento del velo*. In the *Sentencia de 24 de diciembre de 1988*,<sup>319</sup> a bank seized the assets of an insolvent company called *Evapol S.A.* The company *Curipa S.A.* started proceedings against the bank. *Curipa S.A.* claimed that it has rights of property over the assets of *Evapol S.A.* However, the *Tribunal Supremo* decided to lift the corporate veil on grounds of fraud. Both companies were created and administered by the same individual, which used the entities as a dummy to evade obligations. Both companies had no real objective or commercial activity.

#### 3.3.3.4 The Use of the Corporate Veil to Avoid the Law and Contractual Obligations

Regarding the avoidance of the law, the *levantamiento del velo* is a remedy that is applied when a corporate entity obstructs the application of the law. The *Principio de Responsabilidad Patrimonial Universal* is contained in the article 1911 of the Spanish *Código Civil*, which provides "The debtor is liable for the performance of his

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<sup>318</sup> *Ley 22/2003 de 9 de Julio. Ley Concursal.* (BOE núm. 164, de 10 julio [RCL 2003, 1748])

<sup>319</sup> *Sentencia de 24 de diciembre de 1988* (RJ 1988, 9816)

obligations with all present and future property". This principle has been enacted and is enforced by Spanish Courts. However, there are circumstances in which the corporate veil (in the form of a *sociedad anónima*, *sociedad unipersonal* or by using a group structure) is used to avoid this legal obligation. In fact, this is one of the most common corporate veil issues in Spanish case law; some examples being the *Sentencia de 11 de noviembre de 1995*,<sup>320</sup> and the *Sentencia de 30 de mayo de 2005*.<sup>321</sup>

In the *Sentencia de 11 de noviembre de 1995*, a natural person created a corporate entity in order to transfer assets that were about to be seized by the Court. The company was created and owned by the individual and his family. The Court disregarded the veil based on the fact the defendant was using the corporate entity to avoid his obligations. In the *Sentencia de 30 de mayo de 2005*, a corporate entity claimed ownership over the assets of a company subject to proceedings. However, the companies had the same owner. The court lifted the corporate veil in order to prevent the fraud.

As regards contractual obligations, the *levantamiento del velo* has been applied to deal with the corporate veil if used (in the form of a *sociedad anónima*, *sociedad unipersonal* or by using a group structure) to defraud a contracting party. One of the most common contractual relationships in which the corporate veil has been used to defraud is the *contratos de compraventa* (sales contract). An example regarding the *levantamiento del velo* enforcing the payment of monies owed from a sales contract is the *Sentencia del Tribunal Supremo de 30 de mayo de 1998*.<sup>322</sup> In this case, the company *Promocion y Explotacion Hidráulica S.A* sold industrial equipment to *Construcciones Metalicas Fam S.A*. However, the former did not make the payment agreed in the contract. Therefore, *Promocion y Explotacion Hidráulica S.A* started proceedings not only against *Construcciones Metalicas Fam S.A*. but also against its major shareholder and sole administrator, "Don Felix". The claimant decided to sue "Don Felix" because the entity *Construcciones Metalicas Fam S.A*. had no assets to pay for its debts. The Tribunal evaluated whether to ignore the corporate veil on the

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<sup>320</sup> *Sentencia del Tribunal Supremo de 11 de noviembre de 1995* (RJ 1995, 8118)

<sup>321</sup> *Sentencia del Tribunal Supremo de 30 de mayo de 2005* (RJ 2005, 4244)

<sup>322</sup> *Sentencia del Tribunal Supremo de 30 de mayo de 1998* (RJ 1998, 4075)

following grounds: 1) the fact that the company was composed of “Don Felix’s” family, 2) the fact that “Don Felix” owned the majority of shares, and 3) the company did not comply with basic formalities such as accounting registers. Based on these facts the Court decided to ignore the corporate personality and make “Don Felix” pay the monies owed to the claimant.

It is worth mentioning that the evasion of contractual obligations derived from sales contracts are not the only circumstances in which the *levantamiento del velo* has been applied. This doctrine has been applied to enforce laws such as the *artículo 76 de la ley de seguros* (insurance law)<sup>323</sup>, *normas de concurso de acredores* (insolvency law)<sup>324</sup>; solve conflicts in *contratos de arrendamiento* (leasing contracts)<sup>325</sup>, *contratos de presamo* (loans)<sup>326</sup>, *incumplimiento de clausula de no competencia* (covenant to no compete)<sup>327</sup>. However, for the purpose of this work I emphasise *responsabilidad patrimonial* and obligations derived from sales contracts because this doctrine has been applied to a greater extent in these areas.

#### 3.3.4 Requirement for applying *the levantamiento del velo*

The *levantamiento del velo* is a remedy whose application has not been made randomly. The Spanish judiciary through jurisprudence has gradually developed a criterion for the application of this remedy. In the precedent established in 1984 the court based the *levantamiento del velo* on concepts such as *abuso de derecho*, *fraude a la ley*, *buena fe* and *equidad*. Certainly, these concepts have been the subject of criticism, but have been gradually complemented statutory law.

Although fraud was not the core element to justify ignoring the corporate personality in the 1984 precedent, the Spanish court has established the concurrence of fraud in order to apply the *levantamiento del velo* to be imperative; for example, in the *Sentencia de 12 de junio de 1995*,<sup>328</sup> the company *Curtidos Codina S.A* requested the disregard of the veil of the company *Tomás y Nelco S.A*, in order to hold

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<sup>323</sup> *Sentencia de 25 de octubre de 1997*

<sup>324</sup> *Sentencia del Tribunal Supremo de 6 de abril de 2005*

<sup>325</sup> *Sentencia del Tribunal Supremo de 28 de marzo de 2000*

<sup>326</sup> *Sentencia del Tribunal Supremo de 20 de mayo de 2004*

<sup>327</sup> *Sentencia del Tribunal Supremo de 12 de febrero de 1993*

<sup>328</sup> *Sentencia del Tribunal Supremo de 12 de junio de 1995* (RJ 1995,4739)

shareholders of *Tomás y Nelco S.A*, liable for the debts of the company. However, the Tribunal dismissed the request to pierce the corporate veil based on the lack of intention to defraud on the part of the shareholders. The claimant was aware of the financial condition of the defendant and continued trading with the company. Moreover, the claimant had a *contrato de seguro de crédito por incumplimiento* (guarantee), from which it had already recovered part of the claimed debt. The concurrence of fraudulent intention must be proved in order to apply the *levantamiento del velo*.

### 3.3.5 Critical Observation

If the Spanish approach to corporate veil issues is compared with the English and American approach presented in Chapter Two, it can be argued that the Spanish approach has been developed in a more “organised manner”. While the Anglo-American approach has been structured over metaphors and inconsistent case law, the Spanish approach has been developed from what could be argued as more consistent concepts and principles.

I do not consider the Spanish approach superior to the Anglo-American one. However, I do consider the Spanish approach as more consistent when it comes to deal with corporate personality issues. The consistency of the Spanish method can be appreciated in the *doctrina de terceros*, an early practice founded on the extension of liability and developed in case law. The case law about the *doctrina de terceros* has not been based on a case-by-case basis. I attribute this to the fact that Spanish authorities focused on the aspects that make the corporate entity to lose its status of third party, rather than focusing on metaphor debates.

The *doctrina de terceros*, certainly, was a clever means to deal with corporate personality issues. However, the different circumstances presented in each corporate personality case demanded a more complete method. Therefore, the *doctrina de terceros* gradually changed into the current Spanish *levantamiento del velo*.

The current Spanish *Levantamiento del Velo* is the subject of criticism because of the concepts on which it has been structured: fraud, equity and *abuso del derecho*.

These concepts are regarded as vague and inconsistent. However, despite such shortcomings, these concepts are not merely plucked out of thin air; rather they are recognised and contained in Spanish legislation, a factor greatly contributing to certainty. The fact that the law provides a basic definition of fraud and abuse creates the basis to further argue these concepts.

I attribute the systematic development of the Spanish approach to the influence of civil law tradition. This legal tradition is based on formalism and adherence to written law. The Spanish approach has been developed systematically to make it compatible with the Spanish civil law framework. The statutory exceptions to the corporate personality are also evidence of this formalism.

## Summary

The Spanish *doctrina de terceros* was the original method to deal with corporate veil issues in Spain and its gradual development created the basis of the current Spanish doctrine of *levantamiento del velo*. The *Sentencia de 28 de mayo de 1984* was the precedent in which the Spanish judiciary introduced the *levantamiento del velo* and the grounds for its applications. However, the basis on which the *levantamiento del velo* was justified has been subject to criticism by the Spanish academia. The main argument against this precedent is the fact that the concepts of *abuso del derecho*, *fraude a la ley*, *equidad y buena fe* were employed loosely and vaguely. Nonetheless, during the 1990s this precedent gave room for Spanish courts to reflect over the *levantamiento del velo*.

The current Spanish doctrine of *levantamiento del velo* has been developed mainly on judgments of the *Spanish Tribunal Supremo*. This doctrine has been applied in different circumstances yet the most common judgments regarding the *levantamiento del velo* are in cases involving the following areas: *unipersonalidad sobrevenida*, corporate groups, *infracapitalisacion nominal* and avoidance of Legal Rules and Contractual Obligations (mainly in sales and leasing contracts). In some of these areas, statutory rules that prevent the misuse of the corporate veil are currently being developed. However, the *levantamiento del velo* has not lost relevance; rather, legislation and doctrine complement each other.

### 3.4 Piercing the Corporate Veil in Latin America

In Latin America corporate veil cases were rare because the joint stock corporation did not play a particularly relevant role. In other words, if the corporate entity was not in common use, the abuse of the corporate veil was in turn not common. During the end of the Nineteenth Century Latin American countries became newly formed Republics and throughout most of the Twentieth Century suffered civil wars and authoritarian regimes that obstructed economic development. It was not until the late 1970's that Latin American countries have gradually gained political stability and have become more dynamic economies.<sup>329</sup> Consequently, the *sociedad anónima*, and *sociedad de responsabilidad limitada*, among other entities with the attribution of legal personality and limited liability, have been more actively employed. Therefore, corporate veil issues have gradually become more common.

The development of Latin American countries has, nonetheless, not been uniform. Consequently, not all Latin American countries have developed an approach to deal with corporate veil issues. In fact, a majority of Latin American countries do not have an approach to deal with this subject. The few countries that have built an approach to address corporate veil issues and the countries that are in the process of doing so are the ones with considerable economic growth.

In this section, the piercing of the corporate veil in Argentina, Chile, Colombia and Brazil shall be addressed. These are Latin American jurisdictions that, I consider,

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<sup>329</sup> Latin American countries are relatively new. While European powers entered in the industrialization period, Latin American countries were newly formed republics. Throughout the 20th century Latin American countries were subject of civil wars and military dictatorships that stangnated economic development. Examples are the Pinochet's dictatorship in Chile, the military junta that governed Argentina and Noriega's Dictatorship in Panama. However, since the late 70's revolutions and international pressure trigger a process for Latin American countries to become estable democracies. Most of Latin American countries in the region could be consider have experienced an economic "boom" in the 90s. Due to the increase on domestic and foreign investment, which is product of estable democracies that offer legal certainty. See, Dongui, T. & others. *Historia Economica de America Latina desde la Independencia hasta nuestros Dias*. Cambridge: Cambridge University Press; 2002.

have developed the subject of piercing the corporate veil more extensively. As a personal observation, each of these jurisdictions has had a vacuum in their framework for companies. This is thus the reason why each of them has developed its own exceptions to the corporate personality.

#### 3.4.1 Argentina

Argentina is the Latin American jurisdiction that can be considered to have pioneered the piercing of the corporate veil (within Latin America) with the implementation of a statutory rule that directly addresses the disregard of the legal entity.<sup>330</sup> This rule was introduced in 1983 by the Law 22.903. This law modified the “*Ley de Sociedades Comerciales de 1972-Ley No 19,550*”,<sup>331</sup> by adding the Article 54. That Article provides that:

“The liabilities of a corporation used to seek a purpose **beyond the corporate goals**, as a mere instrument to defraud the law, the public policy or the good faith, or to frustrate rights of third persons, will be imputed directly to its shareholders or to the controlling persons who facilitated such activities”.<sup>332</sup>

From reading this Article it can be considered that Argentinean policy makers used the concept of *ultra vires* as a basis for this exception to the corporate personality.<sup>333</sup> Certainly, there is no direct mention of the *ultra vires* doctrine but “an act beyond the

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<sup>330</sup> The principle of *inoponibilidad de la persona juridical* is an initiative that is still considered a breakthrough. No other jurisdiction in the region has established a principle or regulation that directly addresses the disregard of the legal entity. See, Hurtado, J. *Supra note* 304. At page 75

<sup>331</sup> The “*Ley de Sociedades Comerciales de 1972 (Ley No 19,550)*” is the current regulation of the different forms of business associations in Argentina. Moreover, this law includes the regulation of corporate groups, which is a subject not previously addressed in the regulation contained in the “*Codigo de Comercio Argentino de 1890*”.

<sup>332</sup> **Article 54:** *El daño ocurrido a la sociedad por dolo o culpa de los socios o de quienes no siéndolo la controlen, constituye a sus autores en la obligación solidaria de indemnizar, sin que puedan alegar compensación con el lucro que su actuación haya proporcionado en otros negocios.*

*El socio contratante que aplicare los fondos a efectos de la sociedad a uso o negocio de cuenta propia o de tercero está obligado a traer a la sociedad las ganancias resultantes, siendo perdida de su cuenta exclusiva.*

*La actuación de la sociedad que encubra la consecución de fines extrasocietarios, constituya un mero recurso para violar la ley, el orden publico o la buena fe o para frustrar derecho de terceros, se imputará directamente a los socios o a los controlantes que la hicieron posible, quienes responderan solidaria e ilimitadamente por los perjuicios causados.*

<sup>333</sup> An act carried out by a public authority, a company or a fiduciary person is *ultra vires* when it is not within the scope of the powers entrusted to such authority, company or person. See, Greenberg, D. **Stroud’s Judicial Dictionary of Words and Phrases** (8th edition). London: Sweet & Maxwell; 2012.

corporate goals” can be interpreted as an act that is made against the objective of the corporate entity presented in the Memorandum of Association.<sup>334</sup> Through the registration of the Memorandum of Association, the corporate entity comes into existence and to state the objective of the company is one of the conditions for the law to recognise the existence of the corporate entity. If a company acts against this objective, it should be considered as having acted beyond that which was authorised by the law. Certainly, in practice companies may be allowed to act beyond their original objective. However, an act beyond the corporate goals in this context is interpreted as the use of the company as a tool for achieving fraud.

Argentinean academia and judiciary have addressed the rule contained in the article 54 as “*Inoponibilidad de la Persona Juridica*”;<sup>335</sup> and the trigger for this remedy is based on acts beyond the corporate goals combined with a fraudulent intention. The *inoponibilidad de la persona juridica*, besides creating a formal parameter to address the misuse of the corporate entity, expands the scope of the doctrine developed in precedents prior to the rule of *inoponibilidad de la persona juridica*.

The existence of a statutory rule does not make the disregard of the legal entity a frequent practice in this jurisdiction. The Argentinean judiciary emphasises the exceptional application of the rule contained in the Article 54 based on the premise that the uncontrolled application of this remedy may affect legal certainty and undermine the benefits of the entity doctrine. In the case *Pardini v Fredel, SRL y otros*,<sup>336</sup> the Argentinean judiciary refreshed and emphasised the fact that a remedy such as *Inoponibilidad de la Persona Juridica* “must be applied when it is proved that there has been a fraudulent use of the corporate entity and there is no other remedy available.”

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<sup>334</sup> The academia has addressed this circumstance under the concept of “*fines- extrasocietarios*”; a concept that refers to the use of the corporate entity for a purpose different to that established in the articles of incorporation. See, Hurtado, J. *Supra note* 304. At page 76

<sup>335</sup> The concept of *Inoponibilidad* refers to the ineffectiveness of an act. In this context, the corporation’s legal personality is used as a shield against creditors and third parties. The rule contained in the Argentinean LSC is aimed at neutralising the shield created by the legal personality.

<sup>336</sup> *Sentencia de la Camara Nacional de Apelaciones en lo Comercial, Sala C, de fecha 15 de agosto de 2006, caso Pardini v. Fredel, SRL y otros*

The *inoponibilidad de la persona juridical* is a breakthrough. However, it is also a rule with loopholes. Among much criticism of this rule is the fact that it is not certain whether minority shareholders may use it against dominant shareholders. The text in the article provides this remedy in cases where “the rights of third parties are affected”.<sup>337</sup> The rule does not expressly exclude minority shareholders yet in some cases the Argentinean judiciary has maintained that this rule is, nonetheless, not aimed at protecting minority shareholders.<sup>338</sup>

#### 3.4.1.1 The Piercing of the Corporate Veil in Argentina before the Rule of *Inoponibilidad de la Persona Juridical*

Prior to the reform that introduced the rule of *inoponibilidad de la persona juridica*, the Argentinean judiciary had already ignored the corporation’s legal personality. However, areas of Argentinean law where the corporate veil was ignored (bankruptcy law, labour law, family law and tax law) were areas in which there was an interest that had to be protected by the state. Consequently, the corporate personality may have lost relevance when there was a higher interest at risk. One of the most relevant precedents in this context is the case *Swift-Deltec*.<sup>339</sup> *Cia Swift de la Plata S.A* was a subsidiary of “Deltec International”, which was a holding company incorporated in the U.S. In this case, the *Corte Suprema de Justicia de la Nación* (Supreme Court of Justice)<sup>340</sup> decided to disregard the legal personality of *Cia Swift de la Plata* in order to extend bankruptcy proceedings to other companies in the group and to the parent. The judiciary justified the decision to disregard the corporate entity on the basis that the holding company controlled the personality of *Cia Swift de la Plata* and used its influence over the company against the interest of society and third

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<sup>337</sup> See, Grispo, J. **Inoponibilidad de la Persona Societaria**. *Revista de las Sociedades y Concursos*, available at <http://www.iprofesional.com/adjuntos/documentos/09/0000929.pdf> [last visit may 30, 2013] At page 15

<sup>338</sup> Simancas, Maria Angelica C/ Crosby, Ronald S/ Sum. - Ref. Norm.: L. 19550: 54 - 22/12/1997. Cited by Crispo J. *Idem*. At page 15

<sup>339</sup> Sentencia de la Corte Suprema de Justicia de la Nacion, de fecha 4 de septiembre de 1973. **case Cia. Swift de la Plata Sa S/ Quiebra C/ Deltec Arg. Y Deltec Internacional**

<sup>340</sup> The *Corte Suprema de Justicia de la Nación* is the highest court of law of the Argentinean Republic. The Supreme Court functions as a last resort tribunal. Its rulings cannot be appealed. It also decides on cases dealing with the interpretation of the constitution (for example, it can overturn a law passed by Congress if it deems it unconstitutional). The members of the Supreme Court are appointed by the President with the agreement of at least two thirds of the present Senate members in a session convened for that purpose, and can only be removed by an impeachment process called *juicio político* ("political trial"), initiated by the Chamber of Deputies and carried out by the Senate, exclusively on grounds of improper behaviour. See, <http://www.csjn.gov.ar/> [last visit September 10, 2013]

parties. The Argentinean authorities requested the American authorities to enforce judgment against Deltec International. However, the American courts refused to carry out the Argentinean judgment. Although the case *Cia Swift de la Plata* was a case dealing with a corporate group and insolvency proceedings, the principle established in this precedent has been shared in other areas of Argentinean law.

Regarding labour law, the case *Aybar, Ruben E. y otros v. Pizzeria Viturro SRL y otros* is an example of an abuse of the corporate entity in this context. In this case, the defendant company unjustly fired the claimants and transferred their assets to another company. The company that was the employer was left without enough assets to comply with obligations towards its employees. The Court regarded that the transfer of assets was made with no connection to the activities of the employing company. Consequently, the Court deduced that the new corporate entity was used as a tool to defeat workers rights. If the transfer of assets was made as part of a business strategy this could be considered as legitimate, however, that was not the case. Based on this precedent, the Argentinean judiciary established that the use of the corporate entity as a tool for hiding assets in order to defraud employees' rights would trigger the disregard of the corporate personality.<sup>341</sup> It can be appreciated that the Labour Court supported its reasoning in the concept of *ultra vires*. Indeed, this concept plays a relevant role when it comes to deal with corporate veil issues in Argentina.

In the context of family law, the judiciary has established that the use of the corporate entity as a tool to defeat hereditary rights triggers the disregard of the corporate personality. In the case *Astesiano Monica C/Gianina Soc. Com. Acciones*, the defendant created two shell companies to transfer assets that were part of a succession process. The claimants argued that the companies holding the assets were part of a “simulation” aimed at defeating their rights. The Argentinean Court of Appeal evaluated the facts of the case and decided “the corporate entity cannot be used to deprive heirs of their rights. If the corporate entity is balanced against a hereditary right the latter will prevail”.<sup>342</sup>

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<sup>341</sup> *Sentencia de la Sala Segunda de la Corte Nacional de Trabajo de 9 de Mayo de 1973 dictada en el caso Aybar, Ruben E. y otros v. Pizzeria Viturro SRL y otros* D.T 1974-67

<sup>342</sup> La C.N.Com-Sala A 27.2.78 Astesiano Mónica c/ Gianina Soc.Com.Acciones. “en este fallo se sostuvo frente a un derecho de familia y sucesorio, que la personalidad societaria no es una realidad

In context of tax law, a group of companies may be regarded as an economic unit for tax purposes due to the suitability of this structure for schemes of tax evasion; the case *Parke Davis y Cia de Argentina, SAIC* is a prime example.<sup>343</sup> In this case the Argentinean company Park Davies paid dividends to its parent company domiciled in the U.S. The company, Park Davies, wanted to deduct from its taxes the payment of dividends to the parent company. Argentinean tax authorities recognise the individuality of each corporate entity. However, in this particular case the parent company owned 99% of the shares in the Argentinean company. Consequently, tax authorities questioned the individuality of both companies. The fact that the parent company owned 99% of shares made authorities to consider the payment of dividend as a “self-payment”. Authorities emphasised that each corporate entity is recognised as an individual tax payer but in circumstances like the case at hand the preservation of the corporate entity supports an evident tax evasion. In this case the parent company and the subsidiary were reargarded as a unit and the request for tax deduction was denied.

#### Personal Observation

Based on the cited cases I can argue that Argentinean authorities, since an early stage, set *ultra vires* and fraud as the basis for the later rule of *inoponibilidad de la persona juridica*. The Article 54, in which the rule regarding the *inoponibilidad de la persona juridica* is contained, is not something improvised by Argentinean policy makers. Previous to the legal reforms that introduced this rule, Argentinean authorities established the basis for this rule in case law. The *inoponibilidad de la persona juridica* evidences the originality of the Argentinean method to deal with corporate personality issues.

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*sustancial sino más bien accidental y que como tal no puede servir de sostén a una exclusión de herederos legítimos y en consecuencia se desestimó la personalidad jurídica.”*

<sup>343</sup> *Sentencia de la Corte Suprema de la Nación de fecha 31 de Julio de 1973, caso Parke Davis y Cia de Argentina, SAIC*

### 3.4.2 Chile

The Chilean legal framework does not provide a rule that directly disregards the corporation's legal personality in cases of misuse.<sup>344</sup> Alternatively, the judiciary has relied on traditional legal concepts such as *Simulación*, *Acción Pauliana*, and *Fraude a la ley* in combination with the principles of “*buena fe*”<sup>345</sup> (good faith) and “*objeto y causa licita*”<sup>346</sup> (legal purpose) in order to address corporate personality issues.<sup>347</sup> These traditional legal concepts have been adapted to the circumstances involving corporate personality issues.

The legal concept of *simulación* refers to the performance of a fictitious act with the purpose of defrauding the law.<sup>348</sup> In company law, *simulación* applies when a company is created with a fictitious object in order to avoid liabilities and obligations. Although the objective written in the Memorandum of Association is legal, it is not the true reason for the company's existence. In Chilean law there is not a systematic approach to apply *simulación* in this context;<sup>349</sup> instead, the Chilean judiciary has followed the premise that “the *voluntad real* (real intention) will prevail over the fictitious object”.<sup>350</sup> Based on this premise, the claimant must prove the real intention of the individuals behind the veil of incorporation in order to void the acts of the corporate entity, a fact that creates a heavy burden for the claimant.

The *acción pauliana* is a remedy that voids legal acts carried out to defraud creditors.<sup>351</sup> The Chilean judiciary has used this remedy as one means to address the misuse of the corporate entity. If a corporate entity, for example, is created to transfer assets that are a guarantee in another contractual relationship, the creditor may void the transaction and secure the assets.

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<sup>344</sup> See, Hurtado, J. *Supra* note 304. At page 115

<sup>345</sup> art. 1546: “*Los contratos deben cumplirse de buena fe...*”. See, **Código Civil de Chile. Título XII, Del Efecto de las Obligaciones. Libro Cuarto, de las obligaciones en general y de los contratos.**

<sup>346</sup> art. 1445: “*Para que una persona se obligue a otra por un acto o declaración de voluntad es necesario: ... No 3 que recaiga sobre un objeto lícito...*” See, **Código Civil de Chile. Título II, De los Actos y Declaraciones de Voluntad. Libro Cuarto, de las obligaciones en general y de los contratos**

<sup>347</sup> See, Leonelli, P, & Others . **Abuso de la Personalidad Jurídica.** Universidad Católica de Temuco. 2004. Thesis. At page 23

<sup>348</sup> See, Caballenas, G. *Supra* note 291. See also, Becerra, F. *Supra* note 277.

<sup>349</sup> See, Hurtado, J. *Supra* note 304. At page 117

<sup>350</sup> *Ibid*

<sup>351</sup> See, Caballenas, G. *Supra* note 291.

The *abuso del derecho o fraude a la ley* is an action aimed at punishing the person who has used his rights and privileges in an abusive way.<sup>352</sup> In issues involving the corporate entity, the Chilean judiciary have considered that this has to be applied in cases where a person has used the benefits of the corporate entity to avoid liabilities and obligations. However, the concept of *abuso del derecho* clashes with the purpose of the corporate entity, which is to diminish liability.<sup>353</sup> Indeed, what can be considered as an abuse in this context?

In modern commercial practice, it is legally acceptable that shareholders have limited liability.<sup>354</sup> If creditors did not take measures (request personal guarantee or establish interest rates) to protect their credit, it is legally acceptable for them to lose if the company has insufficient assets to repay (as long as the company has been created and operated legitimately). The concept of *abuso del derecho* will be applied when it is proved that a person uses this privilege to intentionally defraud another party.

#### 3.4.2.1 Potential Chilean approach

The mentioned principles and legal concepts have been the means used by the Chilean judiciary to address the abuse of the corporate entity. However, in relatively recent case law the Chilean judiciary has considered the need of a direct remedy against the misuse of the corporate personality.<sup>355</sup> In a precedent established in 2006, the *Corte Suprema de Justicia de Chile* (Chilean Supreme Court)<sup>356</sup> recognised that “the extreme adherence to the separate legal personality may lead to circumstances in

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<sup>352</sup> *Idem*

<sup>353</sup> See, Neuman, T. *La Protección Constitucional de la Empresa: La Individualidad Determinada y la Teoría del Levantamiento del Velo in Sentencias Destacadas*. 2006. Available at [http://www.lyd.com/wp-content/files\\_mf/sentencias/200610.pdf](http://www.lyd.com/wp-content/files_mf/sentencias/200610.pdf) [last visit may 30, 2013] At page 287

<sup>354</sup> *Ibid*

<sup>355</sup> Chilean judiciary addresses the piercing of the corporate veil as *levantamiento del velo corporativo*.

<sup>356</sup> The *Corte Suprema de Justicia de Chile* is the highest court in Chile. It also administrates the lower courts in the nation. It is located in the capital Santiago. In the Chilean system, the Supreme Court lacks the broader power of judicial review — it cannot set binding precedent or invalidate laws. Instead, it acts on a case-by-case basis. Trials are carried out in *salas*, chambers of at least five judges, presided over by the most senior member. Once appointed, a Chilean Supreme Court justice is extremely difficult to remove from office. Justices are entitled to remain on the Court until the compulsory retirement age of 75. Otherwise, a justice can be removed only if he or she incurs in "notorious abandonment of duty" established in the Constitution. The Supreme Court has twenty-one members, called *ministros*. One member is selected to serve a two-year term as President of the Supreme Court. See, <http://www.minjusticia.gob.cl/> [last visit September 10, 2013]

which the legal order is affected. Hence, it is needed to ignore the legal entity when used to commit an abuse”.<sup>357</sup>

Previous to the statement made by the Supreme Court in 2006, in the context of labour law the judiciary had already considered direct exceptions to the corporate personality in the context of corporate groups. The purpose of the Chilean judiciary in disregarding subsidiary and parent company legal personality has been to regard the group as a single economic unit. Addressing the group as a unit has been aimed at preventing the evasion of employers’ obligations towards employees and furthermore to allow the creation of a pool of assets that allow the execution of a judgment. In the case *Rodriguez v. J.R.C. Group y otras*,<sup>358</sup> an engineer sued sixteen companies due to unpaid services. The companies had been properly formed and regarded as independent entities. However, they were all under common management. Moreover, the manager also had the majority of shares in each company. Although the engineer had a contract with each company, the court considered the group of companies to be a sole unit. The Court supported its decision based on the concept of enterprise established in the Labour Code, “An enterprise is an organisation under a common direction, created to achieve a purpose”.<sup>359</sup> The court established that the common management and domicile rendered the group of companies as having been performing as a single unit.

Certainly, the public policy aimed at the protection of workers’ rights was key in the decision to regard the group as unit. However, the decision made by the Chilean court in the cited labour case is not just the product of a need to enforce workers rights, but also to prevent and punish the misuse of the corporate entity.

Following the direct statement in the 2006 precedent, the Chilean Courts have been more open to directly consider ignoring the corporate personality. This can be appreciated in the relatively recent case of *A.G.F Allianz Compañía de Seguros*

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<sup>357</sup> Corte Suprema, Sentencia Rol No 1929 del 21 de junio de 2006, considerando sexto, ratificando una sentencia de la Corte de Apelaciones de Valdivia Rol No 137-06 de fecha 18 de abril de 2006

<sup>358</sup> Sentencia de la Corte Suprema de Chile de fecha 27 de octubre de 2003, causa numero 3248-03, **Rodriguez v J.R.C Group y otras**

<sup>359</sup> Art. 3.3: “ Se entiende por empresa toda organizacion de medios personales, materiales e inmateriales, ordenados bajo una direccion, para el logro de fines económicos, sociales, culturales o beneficos, dotada de una individualidad legal determinada.” See, **Codigo de Trabajo de Chile**.

*Generales S.A. v. Sociedad Naviera Ultragas Limitada y Ultramar Agencia Marítima Limitada*.<sup>360</sup> In this case, a company contracted with Ultragas LTD to tug a “floating dock”. Ultramar LTD, a subsidiary of Ultragas LTD, received and tugged the floating dock. However, during transportation the dock sank. Based on negligence during the transportation of the dock, the insurance company sued the group for damages. The Chilean court considered ignoring the corporate personality based on facts relating to the control and lack of autonomy of the subsidiary. Ultragas LTD owned 99% of Ultramar’s shares and both were under common administration.

#### Personal Observation

The recent acceptance by Chilean authorities of a direct action against the corporate personality supports my premise regarding economic prosperity. Since Chile became politically stable, economic development has been triggered and this in turn has produced corporate personality issues.<sup>361</sup> As I have presented in this section, Chilean authorities have dealt with corporate personality issues by using traditional legal concepts. No direct approach has been developed. I attribute this to the fact that corporate personality issues are on an early stage because the use of the corporate personality is relatively recent in Chile.

#### 3.4.3 Colombia

The Colombian judiciary, like other civil law jurisdictions, has used the traditional legal concepts of *Simulacion*, *Accion Pauliana*, and *Abuso del Derecho* to address the abuse of the corporate personality.<sup>362</sup> However, unlike Chile, the Colombian judiciary has developed a more formal approach. Indeed, statutory rules have been developed to address abuses of the corporate personality. These rules are contained in the following statutes:

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<sup>360</sup> Sentencia de la Corte Suprema de fecha 2 de junio de 2009 (ROL N° 1527-2008) *A.G.F Allianz Compañía de Seguros Generales S.A. v. Sociedad Naviera Ultragas Limitada y Ultramar Agencia Marítima Limitada*.

<sup>361</sup> After Augusto Pinochet’s dictatorship and the introduction of a democratic government in Chile, the country experienced economic development. Legal certainty provided by democratic governments is undoubtedly key for the development of modern economies. See, Dongui T. & others. *Supra note* 329.

<sup>362</sup> See, Gaitan, J. *Marco General del Levantamiento del Velo Corporativo en Colombia*. Gil, M. & others. *Levantamiento del Velo Corporativo*. Colombia: Universidad del Rosario; 2010. At page 50 - 53

- The *Ley 190 de 1995*

This statute provides the judge with the competence needed to apply remedies such as the disregard of the legal entity in order to punish wrongdoers. In the Article 44 of this statute, it is established that, “the authorities can lift the veil of incorporation when it is necessary to determine the individuals behind the corporate entity”.<sup>363</sup> This statute derives from the need of legal devices to combat money laundering and the use of the corporate personality to hide assets part of a judicial investigation.

Before the enactment of this rule, the Colombian judiciary was already aware of the potential of the corporation’s legal personality to be a device to practice illicit acts. The Colombian judiciary had engaged in determining to what extent the corporation’s legal personality should be preserved. In 1993, the Colombian *Corte Suprema de Justicia* (Supreme Court of Justice)<sup>364</sup> established in jurisprudence that the separate corporate personality only has effect in commercial and civil acts, not in penal law.<sup>365</sup> The separate corporate personality has no validity if this is used as a device to obstruct the administration of justice and practice fraudulent acts against the State.<sup>366</sup> This statement by the Colombian judiciary feeds the proposition established in the first chapter, which is based on the prevalence of a public interest over the fiction of the corporate personality.

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<sup>363</sup> *Ley 190 de 1995*, artículo 44: “*Las autoridades judiciales podrán levantar el velo corporativo de las personas jurídicas cuando fuera necesario determinar el verdadero beneficiario de las actividades aelantadas por esta.*”

<sup>364</sup> The *Corte Suprema de Justicia de Colombia* in Bogotá is the highest judicial body in civil and penal matters and issues of criminal and civil procedure in Colombia. The Supreme Court of Colombia is not the highest authority in regards to the interpretation of administrative law, constitutional law, and the administration of the judiciary. The court consists of twenty three magistrates, elected by the same institution in list conformed by the Superior Council of the Judiciary for individual terms of eight years. The court meets at the Palace of Justice in the Bolívar Square of Bogota. <http://www.cortesuprema.gov.co/> [last visit September 10, 2013]

<sup>365</sup> “*El que para efectos comerciales y civiles la persona juridical sea un ente distinto de sus socios, es una verdad que no trasciende el ambito penal.*” See, *Corte Suprema de Justicia, Sala Penal, auto 7183 del 20 de enero de 1993.*

<sup>366</sup> See, Arrubla, J. *El Levantamiento del Velo Corporativo in Colombia*. Gil, M. & others. *Supra note* 340. At page 70

- The *Ley 222 de 1995*.

This law modified the Code of Commerce and the regulation of Companies. One of the most relevant aspects was the creation of the “*Empresa Unipersonal*” (one-man company). Small businessmen have been interested in acquiring the benefits of the corporate entity for individual enterprises. However, the creation of a joint stock corporation or a limited liability company requires the compliance of a series of formalities. Traditional company law requires a company to have at least a minimum of two members. The lack of the required membership may produce the voidance of the company. Therefore, the Colombian legislation made a breakthrough with the introduction of the *empresa unipersonal*, which is a device for commerce that provides the advantages of the corporate entity to a sole entrepreneur.

The objective of the *empresa unipersonal* is to allow a natural or legal person to develop a personal business and enjoy the benefits of separate legal personality and limited liability.<sup>367</sup> This is certainly a device that encourages entrepreneurs. However, during the draft of this law, the potential of this device to be used for practising illicit and fraudulent purposes was also considered. Therefore, in the same Article 71 that creates this entity, the policy makers included an exception. If this form of enterprise is used for fraudulent purposes, the entrepreneur shall answer together with the entity for its debts.<sup>368</sup>

Besides the exception to the *empresa unipersonal* legal personality, this law also included a rule that addressed the disregard of the corporate entity in the context of corporate groups. In the Article 148 (**derogated by the *Ley 1116 de 2006***)<sup>369</sup> the law

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<sup>367</sup> *Ley 222 de 1995, artículo 71: “Mediante la empresa unipersonal una persona natural o jurídica que reúna las cualidades requeridas para ejercer el comercio, podrá destinar parte de sus activos para la realización de una o varias actividades de carácter mercantil. La empresa unipersonal, una vez inscrita en el registro mercantil, forma una persona jurídica”.*

<sup>368</sup> *Idem, artículo 71, Parágrafo: “Cuando se utilice la empresa unipersonal en fraude a la ley o en perjuicio de terceros el titular de las cuotas de capital y los administradores que hubieren realizado, participado o facilitado los actos defraudatorios responderán solidariamente por las obligaciones nacidas de tales actos y por los perjuicios causados.*

<sup>369</sup> The *Ley 1116 de 2006* Law 1116 established the Entrepreneurial Insolvency Regimen in Colombia. The article 61 of the *Ley 1116 de 2006* addressed some aspects that were not covered by the article

established that a parent company may be held liable for the subsidiary's insolvency if the situation of the latter has been the product of the excessive control of the former and decisions made against the interest of the subsidiary.<sup>370</sup> This rule is founded on the dominance of the parent over the subsidiaries, which in some cases is so strong that it leaves the subsidiary with some sort of dependence. However, an argument against a parent company on grounds of this rule may be refuted if the parent proves that the subsidiary's insolvency is a product of other circumstances. The *Corte Constitucional* (Constitutional Court)<sup>371</sup> held in the sentence *C-510/97*: "... if the defendant can prove that its decisions and management was not the cause for the subsidiary's insolvency, the separation of personality and liabilities will be held".<sup>372</sup>

The reforms introduced in the *Ley 222 de 1995* definitely supplemented the Colombian commercial legislation and brought innovation. Firstly, a legal entity that encourages entrepreneurship was introduced. Additionally, an exception to deter its misuse was established. Secondly, a parent company's liability in a case of insolvency was addressed. The Colombian judiciary, based on the concept of control, developed an exception to separate corporate personality, a breakthrough during that period.

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148. First, the article 61 more extensively developed the concept of parent company. It established that a parent company could be a holding or could be a group of companies controlling the subsidiary. Additionally, the article 62 established the expiration of the action, which is 4 years. This was not addressed in the *Ley 222 de 1995*. The *Ley 1116 de 2006* also established that the *Superintendencia de Sociedades*, is the competent authority to address liquidation proceedings in this context.

<sup>370</sup> *Idem*, Article 140, Paragrafo Cuando la situación de concordato o de liquidación obligatoria haya sido producida por causa o con ocasión de las actuaciones que haya realizado la sociedad matriz o controlante en virtud de la subordinación y en interés de ésta o de cualquiera de sus subordinadas y en contra del beneficio de la sociedad en concordato, la matriz o controlante responderá en forma subsidiaria por las obligaciones de aquélla. Se presumirá que la sociedad se encuentra en esa situación concursal, por las actuaciones derivadas del control, a menos que la matriz o controlante o sus vinculadas, según el caso, demuestren que ésta fue ocasionada por una causa diferente.

<sup>371</sup> The *Corte Constitucional de Colombia* is the highest entity in the judicial branch of government in the Republic of Colombia in charge of safeguarding the integrity and supremacy of the Colombian Constitution of 1991 within the Constitutional laws. However it is not the highest court of criminal appeal, civil appeal, administrative law disputes, and the administration of justice. The Supreme Court of Colombia, the Council of State of Colombia and the Superior Council of the Judiciary are the highest courts of appeal for their respective areas of law.

<http://www.corteconstitucional.gov.co/> [last visit September 10, 2013]

<sup>372</sup> *Corte Constitucional, Sentencia C-510/97.*

- The *Ley 1258 de 2008*.

This law creates the *Sociedad por Acciones Simplificada*. The *Sociedad Anónima*, is subject to regulations that make its creation a burdensome process for small entrepreneurs. Consequently, the *Sociedad por Acciones Simplificada* is created as an alternative. The law is flexible in terms of the requirements for its constitution and in turn this form of association has the attributes of legal personality and limited liability. In addition to this, the policy makers developed an exception to the legal personality of this form of business association. In the Article 42 the following is established: if the *Sociedad por Acciones Simplificadas* has been used for fraudulent purposes and against third parties, the shareholders and directors that participated in the fraud shall be held liable.<sup>373</sup>

#### 3.4.3.1 Controversy Between Statutory Exceptions to the Corporate Personality and the Colombian Constitution

The piercing of the corporate veil has been a controversial subject in every jurisdiction and has been challenged on different grounds. In the case of Colombia, the Colombian statutory exceptions to the corporate personality have been challenged at a constitutional level. In Colombia, the case law about piercing the corporate veil is mainly based on decisions from the Colombian *Corte Constitucional* rather than decisions from regular courts.<sup>374</sup> The exception to the corporate entity has challenged rights such as the preservation of the economic order (Article 2)<sup>375</sup> as well as the

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<sup>373</sup> *Ley 1258 de 2008, artículo 42: Cuando se utilice la sociedad por acciones simplificada en fraude a la ley o en perjuicio de terceros, los accionistas y los administradores que hubieren realizado, participado o facilitado los actos defraudatorios, responderán solidariamente por las obligaciones nacidas de tales actos y por los perjuicios causados.*

*La declaratoria de nulidad de los actos defraudatorios se adelantará ante la Superintendencia de Sociedades, mediante el procedimiento verbal sumario.*

*La acción indemnizatoria a que haya lugar por los posibles perjuicios que se deriven de los actos defraudatorios será de competencia, a prevención, de la Superintendencia de Sociedades o de los jueces civiles del circuito especializados, y a falta de estos, por los civiles del circuito del domicilio del demandante, mediante el trámite del proceso verbal sumario.*

<sup>374</sup> See, Garnica, C & others. *Corte Constitucional Línea Jurisprudencial 1997-2007, Levantamiento del Velo Corporativo*. Universidad Sergio Arboleda. 2007. Available at [http://www.usergioarboleda.edu.co/derecho\\_comercial/jurisprudencias/linea\\_jurisprudencial.pdf](http://www.usergioarboleda.edu.co/derecho_comercial/jurisprudencias/linea_jurisprudencial.pdf) [last visit may 30, 2013] at page 193

<sup>375</sup> **Artículo 2.** *Son fines esenciales del Estado: servir a la comunidad, promover la prosperidad general y garantizar la efectividad de los principios, derechos y deberes consagrados en la*

freedom to associate for any legal purpose (Article 38).<sup>376</sup> Freedom of association and the preservation of the economic order are key for the existence for steady economic development and thus for the existence of the corporate personality. In the constitution there are no exceptions to these rights. Consequently, can these statutory exceptions undermine constitutional rights? If so, to what extent can congress legislation override constitutional rights and duties?

The *Sentencia C-865 de 2004* is a relevant precedent in which the Constitutional Court has reflected over this controversy.<sup>377</sup> In this precedent, the Constitutional Court emphasised that the rationale for ignoring the corporate personality is the prevention and punishment of fraud. The court established that “the shareholders will be liable when the good faith is affected and limited liability is used to achieve an objective that is against the purpose of constitutional rights and defrauds third parties”. Indeed, the Constitutional Court approached this dilemma taking into account the concept of the abuse of rights. According to this concept, a right cannot be preserved if it is used to affect other parties’ rights. Additionally, in this precedent the fact that Congress has the authority to regulate the use and limits of the corporate personality was clarified.

#### Personal Observation

Colombian authorities have, I consider, been practical in dealing with corporate veil issues. As already stated in this section, piercing of the corporate veil has been established in specific statutes involving circumstances where this remedy is needed. The case of Colombia supports my premise regarding the existence of a legal need in order for piercing the corporate veil to exist. Were the corporate personality not to be frequently misused and were the *sociedad por acciones simplificadas* to be more

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*Constitución; facilitar la participación de todos en las decisiones que los afectan y en la vida económica, política, administrativa y cultural de la Nación; defender la independencia nacional, mantener la integridad territorial y asegurar la convivencia pacífica y la vigencia de un orden justo.*

<sup>376</sup> **Artículo 38.** *Se garantiza el derecho de libre asociación para el desarrollo de las distintas actividades que las personas realizan en sociedad. Constitución Política de Colombia 1991. Título II, de los derechos, las garantías y los deberes*

<sup>377</sup> Corte Constitucional. *Sentencia C-865 del 7 de septiembre de 2004.* Available at <http://www.corteconstitucional.gov.co/relatoria/2004/C-865-04.htm> [last visit May 30, 2013]

strictly regulated, there would have been no need for a statutory exception to the corporate personality.

#### 3.4.4 Brazil

The piercing of the corporate veil has been present in Brazilian case law since the 1970s.<sup>378</sup> Family, labour<sup>379</sup> and tax law are some of the areas where case law have presented a debate regarding to what extent the corporate personality should be preserved.<sup>380</sup> Some statutes already extended company's liabilities to shareholders.<sup>381</sup> However, these statutes did not explicitly prescribe the piercing of the corporate veil.<sup>382</sup> Therefore, Brazilian Courts were not legally authorised to apply this remedy.<sup>383</sup> There was no direct statutory approach to address corporate veil issues until 1990.

The *Lei No 8.078 de 11 de setembro de 1990* (Consumers' Protection Code) was the first Brazilian statutory regulation that directly addressed the piercing of the corporate veil.<sup>384</sup> In its Article 28, it is established that a judge can disregard the corporations' legal personality if it has been used to the detriment a of consumer's

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<sup>378</sup> See, Reali, R. *Desconsideração da Personalidade Jurídica no Direito Positivo Brasileiro*. Universidad Regional de Blumenau. 2003. Available at <http://www.boletimjuridico.com.br/doutrina/texto.asp?id=327> [last visit may 30, 2013] At page 55

<sup>379</sup> In labor law the entity doctrine is not a doctrinal issue when workers' rights are affected. The judiciary has established that it is not necessary for the concurrence of fraud or abuse of the corporate form. The fact that the company does not have enough assets to comply with its obligation with its workers is enough justification to disregard the corporation's personality and extent liability to the shareholders. The lack of validity in this context has been based on the protection of workers against the abuse of the employer. Clt, art. 2.º, caput). Processo trt/2 SP, 02429200703102003. Sentece cited by, Andrade, F. And Pasqualotto, A. In the paper "*El Levantamiento de la Personalidad Jurídica en el Derecho Privado Brasileño*". 2010. Available at [dialnet.unirioja.es/descarga/articulo/3696745.pdf](http://dialnet.unirioja.es/descarga/articulo/3696745.pdf) [last visit may 30, 2013] At page 98

<sup>380</sup> See, Reali, R. *Supra note 378*. At page 54

<sup>381</sup> The *Lei No 4.137 de setembro de (1962)*, in article 9, established that directors and managers will be personally liable for company's debts, if they have carried out illegal acts during the course of their administrative duties. Available at [http://www.planalto.gov.br/ccivil\\_03/decreto/1950-1969/D52025.htm](http://www.planalto.gov.br/ccivil_03/decreto/1950-1969/D52025.htm) [last visit May 30 2013]. Also, the *Lei 4.729 (1965)*, in article 1 established that courts were allowed to impose criminal sanctions on directors and members of corporations that dishonestly concealed taxes. Available at [http://www.planalto.gov.br/ccivil\\_03/leis/1950-1969/L4729.htm](http://www.planalto.gov.br/ccivil_03/leis/1950-1969/L4729.htm). [last visit May 30, 2013]

<sup>382</sup> See, Camargo, A. **Three Essential Aspects of Corporate Law: A Brief Overview of Brazilian and American Approaches**. *Southern Journal of Law & Trade in the Americas*. (Volume 9) 2003. At page 105

<sup>383</sup> *Ibid*

<sup>384</sup> The *Lei No 8.078 de 11 de setembro de 1990* "*Dispõe sobre a proteção do consumidor e dá outras providências*". Available at <http://www3.dataprev.gov.br/sislex/paginas/13/1990/8078.htm> [last visit may 30, 2013]

rights.<sup>385</sup> The enactment of this rule is derived from a constitutional initiative. The *constituição Federal de 1988* in its Articles 5, 48 and 170 established the defence of the consumer as one of the commitments of the state.<sup>386</sup> Certainly, the judiciary and academia considered that the consumer could be at a disadvantage when against the fraudulent acts performed through the corporate entity. Therefore, the rationale for giving the judge the authority to disregard the legal entity has been the protection of the weaker party (the consumer) against the abuses of a stronger party (the enterprise). Although Article 28 addresses the issue only in a consumer-merchant relationship, this rule established the parameters for the application of statutory piercing of the corporate veil in Brazil.

From the consumers' protection statute, Brazilian policy makers gradually expanded the application of piercing the corporate veil. The *Lei No 8.884 de 11 de junho de 1994*, aimed at the protection of the economic order, in Article 18 (**derogated by the *Lei No 12. 529 de 30 de novembro de 2011***) established that the corporate entity would be disregarded if it had been used in a fraudulent way, beyond its commercial objective or in a negligent manner.<sup>387</sup> The *Lei No 9.605 de 12 de fevereiro de 1998* (environmental law), in Section 4 established that the corporation's

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<sup>385</sup> **Artigo 28:** *O juiz poderá desconsiderar a personalidade jurídica da sociedade quando, em detrimento do consumidor, houver abuso de direito, excesso de poder, infração da lei, fato ou ato ilícito ou violação dos estatutos ou contrato social. A desconsideração também será efetivada quando houver falência, estado de insolvência, encerramento ou inatividade da pessoa jurídica provocados por má administração.*

§ 1º (**Vetado**).

§ 2º *As sociedades integrantes dos grupos societários e as sociedades controladas, são subsidiariamente responsáveis pelas obrigações decorrentes deste código.*

§ 3º *As sociedades consorciadas são solidariamente responsáveis pelas obrigações decorrentes deste código.*

§ 4º *As sociedades coligadas só responderão por culpa.*

§ 5º *Também poderá ser desconsiderada a pessoa jurídica sempre que sua personalidade for, de alguma forma, obstáculo ao ressarcimento de prejuízos causados aos consumidores.*

<sup>386</sup> *A constituição Federal de 1988 no seu artigo 5.º inciso XXXII, determina que o Estado promoverá, na forma da lei, a defesa do consumidor. No artigo 170 inciso V, preceitua que um dos princípios da ordem econômica, fundada na valorização do trabalho humano e na livre iniciativa, é a defesa do consumidor. E finalmente, no artigo 48 no Ato das Disposições Constitucionais Transitórias, determina que seja elaborado o Código de Defesa do Consumidor.*

<sup>387</sup> **Artigo 18:** *O juiz poderá desconsiderar a personalidade jurídica da sociedade quando, em detrimento do consumidor, houver abuso de direito, excesso de poder, infração da lei, fato ou ato ilícito ou violação dos estatutos ou contrato social. A desconsideração também será efetivada quando houver falência, estado de insolvência, encerramento ou inatividade da pessoa jurídica provocados por má administração.*

legal personality will be disregarded when the environment has been damaged and the corporation has frustrated efforts to recover any damage to the environment.<sup>388</sup>

The limitation of the power to disregard a corporation's legal personality to determine statutes can be considered as a gradual introduction of piercing the corporate veil into the Brazilian legal framework. This remedy has steadily expanded from special laws to a whole body of law such as the Civil Code. In 2002, the enactment of the new Brazilian Civil Code included a rule that allows the disregard of the legal entity when it has been used for fraudulent purposes. This rule empowers the judge to consider the disregard of the legal entity throughout any area of Brazilian private law. The Article 50 of this code establishes that:

**“In the case of abuse of the corporate form characterised by acts against a company's purpose or commingling of assets,** a judge may decide, at the petition of the plaintiff or the State Department, if it has the right to intervene, that liability for certain obligations be extended to the personal property or assets of the managers or partners of an entity”.<sup>389</sup>

The phrase “In the case of abuse...” allows an exception to the corporate personality where there has been an evident abuse of its advantages. Definitely, it can be considered that the Brazilian exception to the corporate personality is founded on the concept of *abuso del derecho* (Abuse of Rights). As previously addressed, the principle of *abuso del derecho* establishes that a right is a benefit that is conferred by the law and this benefit can be confiscated if used improperly. Thus, it can be considered that Brazilian law regards corporate personality and limited liability as rights and as such it must be exercised without affecting other parties' rights. However, what can be considered as an abuse in this context? The cited article provides the answer by establishing the use of the company against its original

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<sup>388</sup> **Artigo 4:** *Poderá ser desconsiderada a pessoa jurídica sempre que sua personalidade for obstáculo ao ressarcimento de prejuízos causados à qualidade do meio ambiente. Lei No 9.605 de 12 de fevereiro de 1998 Dispõe sobre as sanções penais e administrativas derivadas de condutas e atividades lesivas ao meio ambiente, e dá outras providências.*

<sup>389</sup> **Artigo 50:** *Em caso de abuso da personalidade jurídica, caracterizado pelo desvio de finalidade, ou pela confusão patrimonial, pode o juiz decidir, a requerimento da parte, ou do Ministério Público quando lhe couber intervir no processo, que os efeitos de certas e determinadas relações de obrigações sejam estendidos aos bens particulares dos administradores ou sócios da pessoa jurídica.*

purpose and commingling of assets as the basis to determine whether there has been an abuse of the corporate entity. Most definitely, the commingling of assets and the inadequate use of the corporate entity are situations that may not necessarily involve fraudulent behavior but are likely to affect third parties. Thus, to pretend to escape liability derived from these circumstances is an abuse of the benefits provided by the corporate entity.

The rationale behind the inclusion of the Article 50 in the new Brazilian Civil Code was based on the need for a means to punish and deter the *Abuso del Derecho*. Certainly, the right to associate under the corporate form can be considered as a right that each individual has. Hence, if this right is used in a way that it affects other parties' rights, it must be ignored.

The judiciary and academia have gradually introduced the piercing of the corporate veil into the Brazilian legal system. It can be considered that this remedy has had a wide acceptance. However, its application is not common. Indeed, the judiciary has emphasised the exceptional application of this remedy. In a 1997 sentence, the Brazilian judiciary held: "The legal existence of a corporation may, in certain cases, be disregarded. However, substantial evidence of abuse of rights or fraud has to be produced".<sup>390</sup> Although the piercing of the corporate veil was introduced as a measure to counter the abuse of the entity doctrine, the Brazilian judiciary has been aware of the vital role the corporate personality has had in the development of the national economy. Consequently, jurisprudence has emphasised the fact that the corporate veil may be pierced only when the abuse of the corporate form has been proven.<sup>391</sup>

#### Personal Observation

In Brazil, as in other jurisdictions, piercing of the corporate veil has been product of a legal need. However, the introduction of this remedy has not been rushed, rather it has been gradual. From specific statutes it expanded to a core regulation such as the

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<sup>390</sup> TAPR-2 Ap. No. 77.829-4 Relator: Juiz Eraclés Messias, 29.08.1997, J. 29.08.1997

<sup>391</sup> "a jurisprudência da Corte, em regra, dispensa ação autônoma para se levantar o véu da pessoa jurídica, mas somente em casos de abuso de direito". See RESP 6932235/mT, Relator: min. Luis Felipe Salomão, 4.o grupo, j. 17.11.2009

Civil Code. The civil law principle of *abuso del derecho* is the backbone of the current Brazilian statutory approach. Like other Latin American jurisdictions studied in this chapter, Brazilian authorities have relied on the tools already provided by the civil law tradition.

## Summary

Latin America qualifies as a region that is currently experiencing economic growth. Furthermore, economic growth is a key factor in the development of any approach to deal with corporate veil issues. The fact that a country is growing renders it necessary to employ all available tools in order to support the economy; among these tools is the corporate personality. With the corporate personality gaining more relevance in Latin American countries, its misuse is also becoming more common. Consequently, policy-makers have reformed existing codes and forged new codes and introduced new laws as well as including exceptions to the corporate personality in cases of fraudulent use.

### **3.5 Comparison of Approaches**

A method for piercing the corporate veil has been individually developed by each jurisdiction. Spain, Argentina, Colombia, Chile and Brazil are countries that follow the civil law tradition and consequently their legal framework for companies tends to be similar. However, the application of a remedy such as piercing the corporate veil varies across these jurisdictions because such a remedy has been developed in accordance to the social, economic and legal needs of each society.

One of the premises this research follows is that the use of the corporate personality is common in prosperous countries. Certainly, the common use of the corporate entity makes the misuse of the corporate entity more common and thus a means to deal with this issue becomes imperative. Spain, Argentina and Brazil are jurisdictions where the piercing of the corporate veil has been widely developed; a factor that can be attributed to the common use of the corporate personality. Although Colombia presents a degree of economic development and thus the corporate personality is in common use, it has been more reserved on this subject.

Spain developed the basis to pierce the corporate veil on case law and later developed statutory exceptions to the corporate personality. As a result, statutes and case law are currently the basis to pierce the corporate veil in Spain. Argentina and Brazil have relied on a statutory exception included in core company law regulations. Colombia has also depended on statutes but this remedy has been limited to specific circumstance and types of business association. The reason for Colombian authorities to create a limited approach can be attributed to the fact that the piercing of the corporate veil clashes with the country's constitution. Hence, in order to avoid major conflict this remedy has been limited to circumstances and areas where there is a high possibility of the misuse of the corporate personality.

The fact that Spain, Argentina and Brazil have developed this remedy with a wider scope of application than has Colombia does not mean that Spain, Argentina and Brazil do not preserve the integrity of the corporate personality. These jurisdictions share the tendency to preserve the corporate personality due to the socio economic benefits provided. This tendency derives from the fear that the excessive and uncontrolled piercing of the corporate veil may undermine the corporate personality. Therefore, in these jurisdictions the piercing of the corporate veil has been considered by the judiciary as a remedy applied in exceptional circumstances.

In contrast, Chile has not developed any statutory exception or doctrinal approach to the corporate personality. In Chile, corporate personality issues have been addressed through the use of the traditional legal concepts by adapting these to the circumstances of the case. I regard the use of traditional concepts as a provisional measure. As I pointed in this chapter, the concept of corporate personality and issues in this context are on an early stage in Chile. It is anticipated that gradually the Chilean judiciary will develop a formal approach to deal with corporate veil issues. It can be argued that Chile may rely on a statute as it chooses to follow the trend of the other Latin American countries. This trend is founded on the conservative nature of the civil law tradition, which makes a statutory approach more suitable for countries with a legal framework based on this tradition.

Certainly, the piercing of the corporate veil is a subject developed differently in each of these jurisdictions. Although, Argentina and Brazil both have a statutory rule on core company law regulations which furthermore expressly deals with the corporate personality, these statutes are of a different form and wording; a fact that has influence on the interpretation and scope of these rules.

Notably, Spain, Argentina, Colombia, Chile and Brazil follow a similar pattern regarding corporate groups in the context of labour law. In labour law, a common issue has been the conflict between the corporate group structure and the enforcement of employees' rights. The companies forming the group are considered independent from each other and each one has its own liabilities, including employment contracts.

In some circumstances a subsidiary does not have assets in order to pay the employees or does not comply with its duties towards the employee; or the employee was contracted by one of the companies but he nonetheless carries out duties for the other companies of the group. Therefore, to what extent are the parent company and the other subsidiaries responsible for the duties of one subsidiary towards its employee? To solve this dilemma the jurisdictions studied in this chapter have decided to regard the companies forming the group as a single economic unit for the purposes of labour law enforcement. Each of these jurisdictions has its own means to justify the concept of the single economic unit in labour law. However, although the approach may be different, the result is the same; to regard the group as a single economic unit.

Another fact that can be established from this research is based on the relevance of traditional legal concepts. As can be appreciated throughout this chapter, these jurisdictions have built their approaches over traditional legal concepts and principles such as *abuso del derecho* and *fraude a la ley*. These concepts already existed in their legal framework and were suitable to justify an exception to the corporate personality. It cannot be denied that these jurisdictions have considered certain aspects of the U.S doctrine. However, it cannot be argued that Spain, Argentina, Colombia, Chile and Brazil have adopted the U.S doctrine. In fact, Hispano-American jurisdictions and Brazil have crafted their own tools to deal with corporate personality issues. Indeed, these jurisdictions have been original with regard to their approaches.

I have to point out the fact that Hispano-American countries and Brazil, share one similarity with the U.S doctrine, which is the fact that these approaches aim directly at attacking the corporate personality. The exceptions to the corporate personality presented in this chapter may be different to the U.S doctrine in structure, but all of these attack directly the corporate entity in order to hold liable the wrongdoers hidden behind it.

In comparison to the English approach to deal with corporate veil issues, I consider Hispano-American countries and Brazil has been more open to deal with the corporate personality. While the English judiciary has looked for alternative means,

the Hispano-American countries and Brazil have directly addressed corporate personality issues.

## **Chapter Conclusion**

In this chapter, the way Hispano-American Jurisdictions and Brazil have dealt with corporate personality issues has been demonstrated. It has been shown that legal tradition has been an influential factor. The passive role of the civil law judge and tendency to adhere to positive law are characteristics of the civil law tradition that make the U.S. doctrine of piercing the corporate veil incompatible with the legal framework of countries that follow this legal tradition. It cannot be denied that the U.S. doctrine has been the subject of attention and studied by civil law academia and judiciary. However, as explained in Chapter Two, the U.S. is a unique and complex jurisdiction. The Hispano-American and Brazilian jurisdictions studied in this chapter present a different reality to that of the U.S. Consequently, the piercing of the corporate veil has been developed in accord to the legal framework and needs of each of these countries.

In this chapter, it can be noted that traditional legal concepts have played a relevant role on the development of approaches to deal with corporate personality issues. The use of traditional legal concepts as a basis for exceptions to the corporate personality is not only a clever initiative but also an initiative that has produced an approach suitable to the legal framework of Spain and Latin American jurisdictions. This thesis does not consider the Hispano-American approach better than the U.S. doctrine as both approaches have pros and cons. However, the fact that the piercing of the corporate veil is a subject addressed individually by each jurisdiction has to be emphasised.

## **CHAPTER IV: The Panamanian *Sociedad Anónima* and the *Levantamiento del Velo* (Lifting the Corporate Veil)**

This chapter is about corporate veil issues in Panama. I have chosen Panama as a main case study due to the peculiar Panamanian framework for companies and the effect this has had over the development of a means to deal with corporate veil issues. Different to the other Latin American jurisdictions studied in Chapter Three, Panama has developed as an offshore financial centre. By doing so the country has developed as an environment that lends itself to commerce, including a flexible regulation for the incorporation and management of companies. Moreover, Panamanian corporations are predominately privately owned. This is partly because public companies are not part of Latin America business culture in general.<sup>392</sup> However, in the case of Panama there are other factors that have contributed to the predominance of private companies. Notably, its small equity market<sup>393</sup> and lack of massive industries,<sup>394</sup> such as mining or manufacture, have played an influential role.

The development of Panama as an offshore financial service centre has not been a recent event. On the contrary, it has been a slow process that started during the early days of Panama being an independent Republic. As a small country with limited resources and a small industry, Panama focused on the development of its service sector, which in turn has led to the current financial services centre. During the development of the Panamanian framework for companies, Panamanian policy makers did not considered an exception to the corporate personality. I personally

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<sup>392</sup> See, Chong, A. And Lopez de Silanes, F. **Investors Protection and Corporate Governance; Firm Level Across Latina America**. New York: Stanford University Press; 2007. At page 1-6

<sup>393</sup> The Panamanian author Carlos Barsallo consider that Panama has a small equity market due to liquidity offered by Panamanian banks, he points that “ in Panama the major issues are driven by the preponderance of banks. Given abundant debt financing, there is little need for equity financing. In addition, institutional investors are largely absent from the equity market”. In addition, the Panamanian author Miguel Eduardo Magallon considers the fact that listed companies have to disclose information to the public as key factor on the lack of interest by the part of Panamanian private companies to go public. Indeed, Panamanian companies are traditionally private and the author Magallon perceives this tendency as one of the causes for the Panamanian equity market to be small. See, Barsallo, C. **Corporate Governance in Emerging Markets**. Corporate governance and enforcement mechanisms in emerging markets. Forum 2. Istanbul, Sabanci Univercity. 17 November 2007 at p 3 . See also Magallon, M. *Como Crecemos el Mercado de Valores Panameño: Propuestas para atraer mas Inversionistas y Emisores*. Available at <http://www.supervalores.gob.pa/educacion-al-inversionista/concursos-de-monografia.html> [last visit 4 august 2013]

<sup>394</sup> In the Panamanian equity market are currently listed ninety-nine companies. See, <http://www.panabolsa.com> [last visit 4 august 2013]

attribute this omission to the lack of a dynamic economy. Certainly, the concept of corporate personality existed in Panamanian company law, but was not exploited until the last twenty years.

During the last two decades, the common use of the corporate personality has triggered a debate regarding the corporate veil in Panama and to what extent it should be preserved. An offshore financial centre such as Panama would probably be inclined to protect the hermetic nature of the corporate personality. However, Panamanian authorities have recognised the fact that the corporate entity cannot be absolute and this can be ignored when used for fraudulent purposes.<sup>395</sup>

Neither a statutory exception nor a doctrinal approach to deal with corporate personality issues currently exists in Panama. Nonetheless, in this thesis it is argued that Panamanian authorities are likely to introduce an exception in order to fill this legal gap. This suggestion is supported by the premise that economic prosperity triggers the use of the corporate personality and this in turn renders the abuse of the corporate personality more common. This thus makes the means to counter the abuse of the corporate entity necessary.

As pointed out in Chapters Two and Three, the piercing of the corporate veil is developed in accord to the legal needs of each jurisdiction. In the case of Panama, I consider that the potential exception is aimed at the Panamanian regulation for *sociedad anónima* (the equivalent to the joint stock corporation). The *sociedad anónima* is the type of business association most commonly employed in Panama due to the flexibility in its creation and management.<sup>396</sup>

In this thesis, the use of the procedural principle of *sana critica* is proposed to supplement the approach to deal with the misuse of the Panamanian *sociedad*

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<sup>395</sup> The Panamanian Supreme Court directly presented its concern in the, *Sentencia, Pleno de la Corte Suprema de Justicia*. 29 de enero de 1991. Later in this Chapter I will present and comment the arguments of the Panamanian Supreme Court on the case decided on this judgment.

<sup>396</sup> The corporation limited by shares is the most frequently used type of business association in Panama and is the usual choice for an offshore operation. See, <http://www.lowtax.net/lowtax/html/jpacos.html> [last visit may 30, 2013] Excelling as a tax planning instrument, Panamanian corporations are widely known and used throughout the world. See, <http://www.offshorepanamaniancorporations.com/> [last visit may 30 2013]

*anónima*. However, before addressing the research question, this chapter will address how the Panamanian framework for companies is composed and how corporate personality issues have been addressed to date. In the first section of this chapter, general aspects of the Panamanian corporate entity will be discussed. To begin, the positive legislation on which the Panamanian corporate entity has been structured will be addressed. Moving on, the value that foreigners and nationals place on the Panamanian corporate entity will be viewed before proceeding to the second section, the *levantamiento del velo* (lifting the corporate veil) and how this subject has been addressed in Panama until now.

#### 4.1 General Aspects of the Panamanian *Sociedad Anónima*

For commercial purposes, different types of business associations in Panama (*sociedad en comandita*, *sociedad de responsabilidad limitada* and *sociedad anónima*) have the attribute of legal personality and shareholders limited liability.<sup>397</sup> However, the *sociedad anónima* is the type of business association most commonly employed.<sup>398</sup> Moreover, this type of business association has been imperative to the development of Panama as a financial service provider.<sup>399</sup> Consequently, as in other jurisdictions studied in this thesis, there is a predisposition of Panamanian courts to preserve the corporate personality.

As explained in Chapter Three, the *sociedad anónima* is the Franco-Hispanic equivalent to the Anglo American joint stock corporation. Panama, like most Latin

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<sup>397</sup> The *Sociedad en comandita* is regulated in the *Código de Comercio de Panama*. Created by the *Ley 2 del 22 de agosto de 1916, publicada en la Gazeta Oficial 2418 de 7 de septiembre de 1916*; the *sociedad anónima* is regulated by *Ley 32 de 26 de febrero sobre Sociedades Anonimas. Publicada en la Gazeta Oficial 5067 de 16 de marzo de 1927*; and the *sociedad de responsabilidad limitada* is regulated by the *Ley 4 de 9 de enero 2009, Publicada en Gazeta Oficial 26202-A*.

<sup>398</sup> The corporation limited by shares is the most frequently used type of business association in Panama and is the usual choice for an offshore operation. See, <http://www.lowtax.net/lowtax/html/jpacos.html> [last visit may 30, 2013] Excelling as a tax planning instrument, Panamanian corporations are widely known and used throughout the world. See, <http://www.offshorepanamaniancorporations.com/> [last visit may 30 2013]

<sup>399</sup> The Republic of Panama is an attractive jurisdiction for the establishment of off-shore corporations. There are many advantages of the Panamanian jurisdiction such as, the competitive costs of incorporation and annual maintenance, the flexibility of the incorporation law and non-taxable income arising out of off-shore business. See, **Doing Business in Panama**. Guide prepared by Baker Tilly Panama S.A, available at <http://www.bakertillyinternational.com/media/36926/doing%20business%20in%20panama.pdf> [last visit may 30, 2013].

American countries, is a former Spanish colony and the Panamanian legal framework has been strongly influenced by Spanish law. Consequently, legal principles and concepts applied to the *sociedad anónima* in Spain and Latin American countries may be similar to those applied in Panama.

#### 4.1.1 Legal Framework for *Sociedades Anónimas* in Panama

The Franco-Hispanic *sociedad anónima* was introduced in Panama in 1916 with the enactment of the Panamanian *Código de Comercio* (Code of Commerce).<sup>400</sup> The *Código de Comercio* establishes the types of business associations that can be used in Panama as well as the general rules regarding their attributes, requirements for existence and also management.<sup>401</sup>

During the decade of the 1920s, a generation of Panamanian Scholars educated in Europe and the U.S. proposed innovations in order to boost the development of the country; among these proposals was the draft of Panamanian corporate law. By that time, the joint stock corporation had become the main vehicle for investment in industrialised countries and developing countries were adopting this type of business association in their company's regulation. Panamanian policy makers envisaged the *sociedad anónima* would play a key role in the development of the country as a financial service provider. However, the regulation of *sociedades anónimas* contained in the *Código de Comercio* was incomplete. Thus, the *Ley 32 de 26 de febrero sobre Sociedades Anónimas* (*Ley 32*) was enacted in 1927 as a body of law dedicated to this type of business association.<sup>402</sup> This law established the requirements and the proceedings necessary to create a *sociedad anónima*. Furthermore, it established parameters for the issue and types of shares as well as the rights that each type of share confers. In turn, this regulation established rules for mergers and established the parameters for the distribution of assets in case of dissolution of the *sociedad anónima*.<sup>403</sup>

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<sup>400</sup> See, *Supra* note 397.

<sup>401</sup> *Código de Comercio de Panama, Libro Primero del Comercio en General. Titulo VIII de las Sociedades Comerciales. Capitulo V sobre sociedades anónimas.*

<sup>402</sup> See, *Supra* note 397.

<sup>403</sup> Among Panamanian law professionals there is a tendency to regard the *Ley 32* as a law based on company law from the U.S (mainly from the State of Delaware). In his research on the Panamanian *sociedad anonima*, the Panamanian author Jorge Fabrega did not find any evidence in the records of the Panamanian Parliament (*Asamblea Nacional de Diputados*) of Panamanian policy makers

With the enactment of the *Ley 32*, the rules of the *Código de Comercio* that directly regulate the *sociedad anónima* were derogated.<sup>404</sup> However, the general rules applicable to the different types of business association contained in the *Código de Comercio* continued to be applicable to the *sociedad anónima*.<sup>405</sup> Moreover, some of the articles contained in the *Código de Comercio* derogated by the *Ley 32* were later restored in order to fill the gaps in the *Ley 32*.<sup>406</sup> The *Ley 32*, since its enactment, has not been subject to any legal reform. Rather, the *Código de Comercio* and other laws have supplemented this law.

#### 4.1.2 The Panamanian *Sociedad Anónima*, a privately owned entity and vehicle for offshore operations

The Panamanian *sociedad anónima* has been predominantly privately owned. Evidence of this is found in the small equity markets, which are currently undergoing development.<sup>407</sup> Company law regulations in Latin America have been developed mainly to deal with privately owned companies and Panamanian corporate law is not an exception. The *Ley 32* does not establish a distinction between public and privately owned *sociedades anónimas*. Moreover, the fact that the *Ley 32* has gaps in aspects such as shareholders' rights and directors' duties among other corporate governance aspects give ground to consider that the original purpose of the law was mainly to regulate privately owned companies rather than public companies. The reason for

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consulting foreign laws when drafting the *Ley 32*. However, the fact that Panamanian policy-makers were influenced by the legal innovations and trends in the U.S and Europe during that time may justify the argument regarding the American roots of Panamanian Corporate law. See, Fabrega, J. *Tratado Sobre la Ley de Sociedades Anónimas, Comentada por Artículos*. Panama: Sistema Juridicos S.A; 2008. At page 17

<sup>404</sup> In article 95 the *Ley 32* establishes that “*Quedan derogadas todas las disposiciones hoy vigentes relativas a las sociedades anónimas.*” [the rules that regulate the *sociedades anónimas* are derogated]

<sup>405</sup> Since the enactment of the *Ley 32* there has been confusion among Panamanian lawyers regarding which rules contained in the *Titulo VIII* of the Code of Commerce were still applicable to the *sociedad anónima*. Indeed, article 95 is not clear. This article just mentions that the rules applicable to the *sociedad anónima* are derogated. It can be considered as obvious that the article 95 makes reference to the rules contained in the *Capítulos V and VI* Code of Commerce (article 359-469), which directly applied to the *sociedad anónima*. However, some lawyers have been confused and considered the whole *Titulo VIII* as not applicable to the *sociedades anónimas*. The Supreme Court of Justice in a *sentencia* dated 31 de Mayo de 1994 cleared this doubt by establishing that the general rules contained in the *Titulo VIII* of the Code of Commerce were applicable to the *sociedad anónima*. The court supports this statement on the fact that there are certain aspects covered by the Code Commerce that are not addressed in the *Ley 32*.

<sup>406</sup> The articles 417-418-420-425-426-427-444-517-524-531-548-556 were reestablished with the article 1 of the *Ley 9 del 2 de Julio de 1946, publicada en la Gazeta Oficial 10,051 de 19 de Julio de 1946*

<sup>407</sup> See, Chong, A. And Lopez de Silanes, F. *Supra note 392*. At page 1

public companies not to be common in this jurisdiction can be attributed to the fact that Panama is a country that has had a slow economic development and consequently the capital market where companies could offer and buy stock was non-existent until the early 1990s.<sup>408</sup> With the economic boost that Panama experienced during the 1990s, the creation of a legal framework for public companies became necessary. However, the *Ley 32* was not reformed; instead, supplementary laws were created in order to deal with matters concerning public companies.<sup>409</sup>

The fact that the Panamanian *sociedad anónima* is predominantly private has encouraged the incorporation of offshore companies. Panama has developed as a financial service provider and one of the main services offered by Panama is the incorporation of offshore companies. In order to structure offshore operations as part of a business strategy, foreign investors seek jurisdictions with flexible regulations regarding the incorporation of companies; an example being tax incentives. A company may be set up in Panama in order to benefit from the Panamanian territorial taxation system thus reducing the tax charges that have to be paid in the country from where the profit originates.<sup>410</sup>

The *Ley 32* offers the type of flexibility sought by foreign investors through establishing flexible requirements for the creation and management of *sociedades*

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<sup>408</sup> See, <http://www.panabolsa.com/> [last visit may 30 2013]

<sup>409</sup> The *Decreto de Gabinete 247 del de 16 de Julio de 1970* established the first parameters for the issue of public equity and created the first *Comision Nacional de Valores* as an institution that supervised the issue of public equity. This law was aimed at motivating the development of a Panamanian equity market. However, it was limited. Moreover, the *Comision Nacional de Valores* was a department of the *Ministerio de Comercio e Industrias* and lacked autonomy. With the creation of the *Bolsa de Valores de Panama* in the 1990s, policy makers became aware of the need of a more complete regulation and stronger institution to regulate the growing Panamanian equity market. Therefore, the *Decreto Ley 1 de 8 de Julio de 1999* (Published in the *Gazeta Oficial 23,837 del 10 de Julio de 1999*) was enacted to cover the legal needs in this context. This *Decreto* created the *Comision Nacional de Valores* as an autonomous entity in charge of supervising the Panamanian equity Markets and established the regulations for the *Mercado de Valores de Panama*. See, <http://www.supervalores.gob.pa/informacion-general/historia.html> [last visit may 30 2013]

<sup>410</sup> Territorial taxation consists in the payment of taxes only for the income generated inside the territory of the country. Income generated abroad will not be subject to tax. In Panama the historical principle of “territorial taxation” has been in force throughout the fiscal history of the country. Strict adherence to this principle in legislation, administrative regulation and court decisions partly accounts for the extraordinary development of Panama as a base for offshore companies. See, Fabrega, J. **Panama como centro para la Estructuración de Transacciones Internacionales o Extraterritoriales y su diferencia con los Paraísos Tributarios o Tax Havens**. 2004. Available at JP Fábrega - fabamm.com [last visit may 30, 2013] At page 20 to 27. See also, Spitz & Clarke. **Offshore Service, Introduction: Comentario in Offshore Services**. U.K: Butterworths; 2005. At page 6 [Pan. 62]

*anónimas*. In this law there is no minimum capital requirement nor is there a restriction regarding the persons that can use this type of entity. It is established that two or more persons with legal capacity (of any nationality, not necessarily a Panamanian resident) can create a *sociedad anónima* as long as it is for a licit purpose.<sup>411</sup> Moreover, the *Ley 32* did not create an authority to supervise the activities of the *sociedades anónimas* such as the *Superintendencia de Sociedades*, which is an institution that exists in other jurisdictions such as Colombia and Chile.<sup>412</sup>

The use of the Panamanian *sociedad anónima* on a domestic level, on the other hand, differs from the use that a foreigner commonly gives to the *sociedad anónima*. Panamanian domestic corporations are employed for their traditional purpose, which is to participate in a commercial enterprise and benefit from the rule of limited liability. However, the fact that Panamanian nationals also use the *sociedad anónima* for other purposes such as tax avoidance and the protection of assets should not be overlooked.

Certainly, there are differences between the Panamanian offshore and domestic *sociedades anónimas* regarding the objective of their existence. However, Panamanian offshore and domestic companies have legal personality, which tends to be equally preserved by the Panamanian judiciary.

## **4.2 Corporate Personality and the Principle of Limited Liability in the Panamanian Legal Framework**

As mentioned in the first chapter, legal personality and limited liability are different concepts but closely related. The Panamanian *sociedad anónima*, as an equivalent to the Anglo-American corporate entity, has the attributes of legal personality and limited liability. Panamanian courts tend to preserve the integrity of

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<sup>411</sup> *Ley 32*, article 1: *Dos o más personas mayores de edad, de cualquier nacionalidad, aun cuando no estén domiciliadas en la República, podrán constituir una sociedad anónima para cualquier objeto lícito, de acuerdo con las formalidades prescritas en la presente ley.*

<sup>412</sup> A *Superintendencia de sociedades* can be defined as a regulatory agency that oversees the creation and management of corporations. In Colombia this agency was created by the *Ley 58 de 1931*. See, <http://www.supersociedades.gov.co/ss/drvisapi.dll?MIval=ppal> [last visit may 30 2013] In Chile the existence of an entity that oversees the activity of *sociedades anónimas*, was considered since the enactment of the Chilean Code of Commerce in 1865 but was formally established by the DFL N°251 del 22 de mayo de 1931. [http://www.svs.cl/sitio/acerca/quees\\_resena.php](http://www.svs.cl/sitio/acerca/quees_resena.php) [last visit may 30, 2013]

the joint stock corporation. Indeed, besides the flexible regulation for *sociedades anónimas*, the Panamanian courts' tendency to preserve the corporate personality is another factor that has motivated foreign investors to create Panamanian offshore companies. However before explaining the rationale on which Panamanian courts preserve the corporate personality, the legal framework on which the legal entity and limited liability were founded shall be briefly addressed.

Panama, like other civil law jurisdictions, establishes the concept of person for legal purposes in its *Código Civil* (Civil Code).<sup>413</sup> The *Código Civil* is structured in five *Libros* (Books) but for the purpose of this section only the "*Libro Primero*", whose title is "*De Las Personas*", shall be mentioned. This book establishes the definition of "person", the types of person (natural and legal) and all matters concerning the existence, capacity, relationships and extinction of the "person".

In Article 38, the *Código Civil* establishes, "a person can be natural or juridical. Natural persons are all humans of any age, sexual gender and social status. Juridical persons are the religious, political, public or commercial entities with rights and obligations, who are represented by a natural person."<sup>414</sup> The concept of "person" and the rules established in the *Libro Primero* of the *Código Civil* form one of the pillars of the Panamanian Corporate personality. However, the attribute of legal personality is not conferred to the *sociedad anónima* through the rules contained in the Civil Code. The *Libro Primero* of the Civil Code establishes that business associations can be considered as juridical persons<sup>415</sup> who can own assets, sue or be sued.<sup>416</sup> However, the same rules establish that business associations will be regulated by the rules in the Code of Commerce.<sup>417</sup> As is previously mentioned, the Code of Commerce regulated

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<sup>413</sup> ***Código Civil de la República de Panama***. Created by the *Ley N° 2 de 22 de agosto de 1916*. Publicada en la *Gaceta Oficial N° 2.404 de 22 de agosto de 1916*.

<sup>414</sup> ***Código civil*** Article 38 establishes "*Las persona son naturales o jurídicas. Son personas naturales todos los individuos de la especie humana cualquiera que sea su edad. Sexo, estirpe o condición. Es persona juridical una entidad moral o persona ficticia de caracter político, público, religioso, industrial o comercial, representada por persona o personas naturales, capaz de ejercer derechos y de contraer obligaciones.*"

<sup>415</sup> Idem Article 64: "*Son personas juridicas: ... (6°) Las asociaciones civiles o comerciales a las que la ley concede personalidad propia independiente de la de cada uno de sus asociados.*"

<sup>416</sup> Idem Article 71: "*Las persona jurídicas pueden adquirir o poseer bienes de todas clases, así como contraer obligaciones y ejercitar acciones civiles o criminales, conforme a las leyes y reglas de su constitución.*"

<sup>417</sup> Idem Article 70: "*Las sociedades a que se refiere el ordinal 6° del articulo 64 se regirán por las disposiciones de este Código relativas al contrato de sociedad y por las del Código de Comercio.*"

all matters relating to business association in the early days of the Panamanian legal system. The Code of Commerce in its Article 251 established “the types of business associations created in accordance to the rules of this code will have legal personality different from that of its members”.<sup>418</sup> Article 251 is part of the rules contained in the *Titulo VIII* of the Code of Commerce that apply to all the forms of business association regulated in this Code, including the *sociedad anónima*.

The enactment of the *Ley 32* diminished the influence of the Code of Commerce on the regulation of the *sociedad anónima*. However, rules like the one contained in Article 251 still play a relevant role in the legal framework for *sociedades anónimas*.

The *Ley 32* was enacted with the purpose to cover aspects, which the Code of Commerce did not cover such as the powers of the *sociedad anónima*, which are contained in its Article 19. Some of the powers established in this article are that a *sociedad anónima* can sue and be sued; and manage its own assets. However, a curious detail that is worth mentioning is the fact that the *Ley 32* does not expressly mention that the *sociedad anónima* is a legal person that exists apart from its shareholders; rather, the Panamanian *Código de Comercio* confers the attribute of legal person to the *sociedad anónima*. The *Ley 32* can be considered to have left the attribute of legal personality as something that can be deduced from the interpretation of the law.

In contrast to the situation of the concept of legal personality, the *Ley 32* has been clearer regarding the principle of limited liability. The Article 39 of the *Ley 32* expressly establishes that shareholders are only liable to the creditors of the company to the extent of their share in the company’s assets.<sup>419</sup> In contrast, the rules of the *Código de Comercio*, which are still applicable to the *sociedad anónima*, do not directly refer to the principle of limited liability. Rather, in the Article 267, it is established that the shareholders will receive profit and be liable for the company’s losses in accordance to what has been agreed among the shareholders. In the case of

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<sup>418</sup> *Código de Comercio* Article 251 establishes “*La sociedad mercantil constituida con arreglo a las disposiciones de este código, tendrá personalidad jurídica propia distinta de la de los socios para todos sus actos y contratos*”

<sup>419</sup> *Ley 32* article 39 establishes “*Los accionistas solo son responsables con respecto a los acreedores de la compañía hasta la cantidad que adeuden a cuenta de sus acciones;...*”

not reaching an agreement, each shareholder will receive profit and will be liable for the company's losses in accordance to his contribution to the corporate assets.<sup>420</sup>

It can be considered that the *Código de Comercio* established limited liability to be optional, while the *Ley 32* established limited liability to be a fixed rule. Unquestionably, limited liability can be established or put aside by, for example, creating a contract clause. However, the fact that the *Ley 32* established limited liability as a formal rule strengthened the existence of shareholders' limited liability in the context of *sociedades anónimas*.

The concept of legal personality and limited liability are to be found in the midst of in the regulations that compose the Panamanian legal framework for *sociedades anónimas*. They are not grouped together under one regulation nor extensively defined. The Panamanian *Corte Suprema de Justicia*<sup>421</sup> has done the task of condensing and systematically explaining these concepts. In the legal precedent established in the *sentencia de 22 de julio de 1994* the Supreme Court concluded that "...the *sociedad anónima* is an entity with legal personality different from that of its shareholders. The obligations of the shareholders are limited to their contribution to the company's assets."<sup>422</sup> Although Panamanian law and case law have recognised that the *sociedad anónima* is a legal entity that confers limited liability to its shareholders, in the same *sentencia* the Panamanian *Corte Suprema de Justicia* also recognised the fact that the *sociedad anónima* could be used to commit illicit acts. In this precedent the court also states:

*“ Debe entenderse que el instrumento de la personaría jurídica con mucha frecuencia ha sido utilizado para sanear ilícitos, llegando la jurisprudencia a adentrarse a ella con el propósito de determinar quiénes se encubren detrás, a fin de aplicarles la ley como si la persona jurídica no existiera. [If the juridical person has*

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<sup>420</sup> *Código de Comercio* article 267 establishes “*La participacion de los socios en los beneficios o las pérdidas se ajustará a lo que estuviere convenido. A falta de estipulacion cada socio capitalista deberá tener una parte de los beneficios o las pérdidas proporcional al valor de su aporte. ...*”

<sup>421</sup> See, *Supra* note 15.

<sup>422</sup> “... la *sociedad anónima* es un ente con personería jurídica propia, distinta a sus accionistas. Las obligaciones del accionista se limitan exclusivamente a sus aportes...” See, *Sentencia. Pleno de la Corte Suprema de Justicia. 22 de Julio de 1994*, precedent cited by Fabrega J, *Supra* note 403. At page 223 - 224

been used as a vehicle to carry out illicit acts, the existence of corporate personality would be ignored so that the law could be enforced on the wrongdoers hiding behind corporate personality].”<sup>423</sup>

The wording in this precedent demonstrates that the Panamanian judiciary recognise the fact that the existence of the corporate personality cannot be supported if it is used to achieve an illicit purpose. As argued throughout this thesis, the use of the corporate personality creates situations that may produce an unfair result for creditors and third parties. Thus, *illicit*, *immoral* and/or *fraud* are words that must not be used loosely. In this statement Panamanian Supreme Court was not clear regarding what could be considered as illicit in this context. However, in the cited statement the phrase “to carry out illicit acts”, I consider, refers to the intention to affect another party, which in Panamanian criminal law is addressed as “*Dolo*”.<sup>424</sup> Indeed, the corporation is a fiction that performs based on the intentions of the individuals behind it.

The Panamanian Supreme Court has considered the piercing of the corporate veil. However, this remedy has not been widely applied in Panama.<sup>425</sup> The incorporation of offshore companies represents a profitable business for Panamanian banks and law firms and is also a good source of income for the State. Moreover, on a domestic level the corporate personality has allowed small Panamanian entrepreneurs to grow. Consequently, Panamanian courts have carefully analysed the application of this remedy due to the negative effects it could produce. Notably, if the corporate personality were to be easily disregarded, Panama would lose ground against other

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<sup>423</sup> *Ibid*

<sup>424</sup> The concept of *dolo* refers to the intention to harm or achieve an unlawful result. In the article 26 of the Panamanian Penal Code it is considered necessary the concurrence of *dolo* in order to consider an act as criminal. See, *Código Penal de la República de Panama*. Adoptado por la Ley 14 de 2007, con las modificaciones y adiciones introducidas por la Ley 26 de 2008, la Ley S de 2009, la Ley 68 de 2009 y la Ley 14 de 2010. Publicado en la Gazeta Oficial, lunes 26 de abril de 2010.

<sup>425</sup> The author Pedro a Barsallos in his Paper “*La Doctrina del Velo Corporativo*” describes the Panamanian *sociedad anónima* as “hermetic”. He used this adjective to describe this type of business association because of the tendency that Panamanian courts have to preserve the separate existence of the corporation from that of its shareholders. However, the adjective used by the Author Barsallos is, I consider, too strong. The conference paper written by Barsallos was presented in 1996, a period when piercing the corporate veil was a relatively recent subject in Panama. Therefore, this was an early moment to consider Panamanian corporate personality as absolute. Certainly, Panamanian courts may be reluctant to ignore the corporate personality. However, this does not mean that the Panamanian judiciary cannot adopt a more balanced posture regarding the application of this remedy, a point I will address through the next section of this chapter. See, Barsallo, P. *Supra note 32*.

offshore financial centres. For foreign investors, the advantages provided by the Panamanian corporate personality are essential for their business strategy. I believe the easy disregard of the legal personality may make investors lose interest in the Panamanian *sociedad anónima*. Furthermore, on a domestic level the uncontrolled disregard of the corporate personality would make Panamanian entrepreneurs reluctant to participate in commercial adventures that in turn may produce a positive effect in the country due to the risk enterprise may pose to investors' personal assets.

There is a dilemma regarding the application of piercing the corporate veil. On the one hand, the fact that the corporate personality cannot be used as an instrument for the practice of illicit acts is accepted. On the other hand, the corporate personality should not be ignored merely because someone alleges fraud, since this would produce a negative effect on the country. However, despite this controversy, piercing the corporate veil is a remedy that has been acknowledged by Panamanian authorities.

### **4.3 The Panamanian Corporate Personality and the *Levantamiento del velo***

The Panamanian legislation for companies had not and still has not any direct exception of the corporate personality. It was not until the early 1990s that the Panamanian Supreme Court of Justice directly applied the disregard of the legal entity based on grounds of criminal fraud.<sup>426</sup> Since then, in the few cases where the Panamanian courts have considered ignoring the personality, this remedy has been addressed as “*Levantamiento del Velo Corporativo*” (lifting the corporate veil).

The *levantamiento del velo* has been developed based on case law and the range for its application has been mainly in cases involving fraudulent acts. Throughout this thesis the reader's attention has been drawn to the fact that fraud in this context does not have a concrete definition. Thus, each jurisdiction has defined, in accordance to its own particular needs, what can be considered fraudulent behaviour and what may trigger the piercing of the corporate veil. In the case of Panama, the Panamanian Supreme Court of Justice has limited the circumstances that can be considered as fraud in this context. These are:

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<sup>426</sup> See, *Sentencia, Pleno de la Corte Suprema de Justicia*. 29 de enero de 1991

1) The use of the corporate entity to hide assets that are part of a judicial investigation regarding a criminal act that happened inside the territory of the Republic of Panama.

2) Circumstances where the corporate personality has been used as part of a scheme to evade obligations.

Pleas to disregard the corporate veil are likely to be rejected should they not fall under one of these circumstances; for example the case *Sentencia del 31 de enero de 1995*.<sup>427</sup> In this case, the defendant was a company called Petromin Shipping Company (Petromin). It was sued for breach of contract. During the proceedings, the claimant requested the seizure of a ship that belonged to one of Petromin's subsidiaries called "Borzesti Inc". The Panamanian Maritime Court decided in favour of the claimant and seized a ship that belonged to Borzesti, Inc. The defendant appealed and argued that the ship belonged to Borzesti Inc, a company with a legal personality and autonomy and which was not part of the contract subject of controversy, thus not being part of the proceedings. Although Petromin owned the majority of shares of Bozesti Inc., the Supreme Court decided in favour of the defendant and reversed the decision of the Maritime Court based on the fact that there was no fraud or abuse derived from the control of Petromin over Borzesti Inc. Borzesti Inc was a legitimate company with its own operations. Consequently, there was no reason to omit the separate legal personality of both companies and allow the issues of Petromin affect Borzesti Inc. The Supreme Court determined that both were different legal persons with their own rights and obligations.

In addition to establishing the trigger for applying the *levantamiento del velo*, Panamanian case law has also established that this remedy is to be applied in exceptional circumstances.<sup>428</sup> As previously mentioned, Panamanian authorities have been careful when considering the piercing of the corporate veil. Although a ground

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<sup>427</sup> See, *Sentencia de la Corte Suprema de Justicia de Panamá, Sala I Civil, de fecha 31 de enero de 1995*.

<sup>428</sup> "La desestimación de la personal jurídica sólo puede adoptarse en circunstancias excepcionales como las previstas en este caso..." See, *Supra* note 426. At page 78

for the application of this remedy has been established, its exceptional nature has been emphasised in order to prevent its uncontrolled application.

#### 4.3.1 Early Panamanian Corporate Veil Issues

Although the piercing of the corporate veil is a relatively new subject in Panama, corporate personality issues have never been left uncontrolled by the Panamanian judiciary. Before the *levantamiento del velo* was introduced as an available remedy against corporate entity issues, Panamanian authorities ignored the corporate personality in public law cases; an example is the *Sentencia de 24 de febrero de 1964*, which is one of the earliest Panamanian precedents in which the corporate personality is ignored.<sup>429</sup> In this case, Mr. Maruicio Menasche was an individual investor sanctioned with the inability to contract with the government because he had previously failed to comply with other governmental institutions. However, Mr. Menasche used the legal personality of a company to participate in a *licitación pública* (a call for bids). The Supreme Court did not mention the disregard of the corporate personality. However, in the *Sentencia* the court considered that Mr. Menasche used the legal entity as an instrument to avoid his sanction. Therefore, the existence of the corporate entity was omitted by the Court to impede Mr. Menasche avoiding his sanction. In the cited case, the Supreme Court ignored the corporate entity to enforce a penalty. Indeed, the imposition of a public law sanction was deemed to prevail over the principle of corporate personality.

In Panama, early exceptions to the corporate personality arose mainly in areas of public law such as tax and administrative law. Following the premise established in Chapter One, the cases that occur in the realm of public law can be considered not to present a real corporate veil issue. This statement is supported by the fact that the state is usually a party in public law cases. The fact that the State is a party to a public law case creates a different scenario from that presented in a private law case. The State acts to defend and execute public policies and in this circumstance, public interests tend to prevail over the corporate personality

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<sup>429</sup> See, *Sentencia de la Corte Suprema de Justicia de Panamá, Sala III de lo Contencioso Administrativo, de fecha 24 de febrero de 1964, caso Mauricio Menasche y Cía.*

Throughout this thesis, when explaining the piercing of the corporate veil in the other jurisdictions subject of study, the piercing of the corporate veil in private law and public law has been kept separate. However, in Panama, the few cases involving a situation where the legal entity has been directly or indirectly ignored and on which the current Panamanian *levantamiento del velo* has been shaped, have involved elements of public law. Therefore, for the purpose of this thesis the considerations of the Panamanian *Supreme Court* on cases involving the corporate entity and the State cannot be omitted.

Early Panamanian corporate personality issues were also handled through statutory rules that contained a direct or indirect exception to the corporate personality. An example is in the Panamanian Labour Code, Article 92, in which it is held that the extension of liability to the shareholders is triggered by the creation or use of an already existing juridical person with the intention to avoid liabilities towards the employees of the company.<sup>430</sup> An example regarding the application of this regulation is the case decided by the *Sentencia* dated 21 de enero de 1982.<sup>431</sup> This judgment decided a labour case in which an employer tried to use a corporate entity to avoid his obligations towards his employee. The employer owned a workshop in which the employee worked. After the judgement was awarded in favour of the employee, the defendant created a *sociedad anónima* to transfer out assets. The employer and members of his family owned the shares of the *sociedad*. Moreover, the workshop and the *sociedad* shared the same facilities. The court did not expressly mention the disregard of the legal entity but it held the employer liable on grounds that a legally established company was used as a means to avoid an obligation toward the employee.

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<sup>430</sup> Panamanian **Labour Code**, article 92: “Cuando por actos simulados o fraudulentos y a través de la creación u operación de la persona jurídica se elude el cumplimiento de obligaciones laborales de una persona jurídica, el trabajador de dicha persona jurídica podrá, además, reclamar sus créditos laborales a los accionistas, socios o miembros.” See, *Decreto de Gabinet 252*(Publicado por la Series Legislativa. 1971- Pan. 1)- (this code was modified by the *Ley N° 44 de agosto de 1995*). See also <http://www.leylaboral.com/panama/Normaspanama.aspx?item=1&bd=45> [last visit may 30 2013]

<sup>431</sup> See, *Corte Suprema de Justicia, Recurso de Casación Laboral. Magistrado Ponente: Lao Santizo Pérez. Gladis Chichao vs Taller Quirós y Elia Quiroz. 21 de enero 1982*

Certainly, statutes in different areas of law have rules that override the corporate personality in order to protect a public interest. Another example is contained in the *Ley de Contratación Pública de 1995 (currently derogated)*.<sup>432</sup> Although the *Ley de Contratación Pública de 1995* is no longer in force, the wording of its Article 46 (Section 3) provides a good example of a measure that is intended to prevent anticompetitive practices, which are against public interest. Under this rule, the circumstances in which a public institution may suspend the call for bids are contained. In the Section 3 of this Article, it is established that if the companies which participate in the call for bids are related, the call for bids will be suspended. In this section, the law establishes that if at least 50% of the shares of one company belong to another company, both share a similar board of directors and there is a degree of control of one company over another, then there is a corporate group. In this section there is no mention of the disregard of the legal entity. However, for the purposes of the call for bids, the participating companies cannot be related. If they are related, they will be regarded as a single unit despite each having its own legal personality.

#### 4.3.2 The current *Levantamiento del Velo Corporativo* in Panama

The piercing of the corporate veil was directly addressed and recognised by the Panamanian Supreme Court of Justice in a *sentencia* (dated January 1991) to be an available remedy.<sup>433</sup> In the case decided by this *sentencia*, the defendant tried to use a Panamanian *sociedad anónima* called *Diberor S.A* to hide assets that were related to criminal operations. The fact that these assets were transferred to a corporate entity made the judicial investigation part of the proceedings difficult. However, during investigations, the authorities found that *Diberor S.A* was constituted and controlled by the defendant and members of his family. The Supreme Court recognised that in normal circumstances the separation of assets of the corporate personality and the controlling shareholder must be preserved. Nonetheless, the Supreme Court considered that in cases in which the corporate entity has been used to hide assets in order obstruct the investigations part of judicial proceedings, the legal personality cannot be preserved. Therefore, the legal entity was disregarded in this case.

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<sup>432</sup> This law was derogated by the *Nueva Ley de Contrataciones Públicas, Ley No 22 de 27 de junio de 2006*.

<sup>433</sup> See, *Supra note 426*.

In this precedent, the disregard of the legal entity was catalogued as a remedy applied in exceptional circumstances, such as the one dealing with the decided case where the corporate entity was used to hide assets that had had a connection to a criminal act committed inside the territory of the Republic of Panama.

In the precedent established in the *Diberor* case, the Supreme Court created the grounds on which the *levantamiento del velo corporativo* in Panama has been founded. The position of the Panamanian Supreme Court in the *Diberor* case was later followed in a controversial Panamanian case decided under the *Sentencia de 16 de febrero de 1996*.<sup>434</sup> In this case, foreign authorities requested the Panamanian *Ministerio Público* (Prosecutor's Office) to investigate a Panamanian company suspected of receiving illegal funds from an Italian company. The *Ministerio Público* proceeded to confiscate documents that were held in the office of the company's resident agent, the law firm Patton Moreno & Asvat. The resident agent presented the Supreme Court with an *Acción de Amparo* (writ of amparo). The resident agent claimed that the constitutional rights of the legal person were violated and information obtained from the confiscated documents had to be kept as confidential. On the other hand, the prosecutor in charge of the investigation argued that he decided to pierce the corporate veil in order to avoid the use of the Panamanian *sociedad anónima* for illicit acts on an international level (i.e. the use of the corporate entity for money laundering).<sup>435</sup> In this *sentencia*, the Supreme Court decided in favour of the resident agent. Firstly, the request was made to the wrong authority. When requiring the investigation of an issue in the territory of Panama, international authorities must present their request to the Supreme Court "*Sala Cuarta de Negocios Especiales*".<sup>436</sup> Therefore, the request to the *Ministerio Público* was invalid based on the fact that this authority did not have competence in the matter. Secondly, the argument of the prosecutor was invalid based on the fact that the prosecutor did not have the competence to determine whether or not to ignore the corporate personality. Moreover, the argument on which the prosecutor tried to justify his action against the corporate personality did not fall under the scope of what had already been

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<sup>434</sup> See, *Sentencia de la Corte Suprema de Justicia de Panamá, Sala en Pleno, de fecha 16 de Febrero de 1996*. (Ref. núm. 199602)

<sup>435</sup> *Idem.*, At page 2

<sup>436</sup> The Panamanian Supreme Court is divided in four *Salas*: The *Sala Primera*, deals with civil law matters, the *Sala Segunda* deals with Penal law matters, the *Sala Tercera* deals with administrative law matters and the *Sala Cuarta sobre Negocios Especiales*.

established in the *Diberor* case as a trigger for piercing the corporate veil (“The corporate personality will be disregarded if it is used to hide assets that have a connection with a criminal act committed inside the territory of the Republic of Panama”). In the wording of this *sentencia*, the Supreme Court also emphasised the fact that the corporate personality must be respected unless strong reasons motivate the disregard of this principle existed.

The use of the Panamanian corporate personality as a device to hide assets related to criminal acts was the only circumstance accepted by the Panamanian judiciary to justify ignoring the corporate personality.<sup>437</sup> However, the misuse of the Panamanian corporate entity has not only been limited to hiding assets. The fact that this entity could be used as part of a scheme to evade obligations became present in this jurisdiction in the case decided by the *Sentencia de 20 de diciembre de 1999*.<sup>438</sup> This *sentencia* decided a liability issue in a case involving a Panamanian group of companies. In this case, the company *Casa Blanca Holding Corporation* (CB) was considered to have been manipulated by its shareholders (the Homsany family). Moreover, it was suspected of receiving funds in a fraudulent manner derived from loans given by the Panamanian *Banco Nacional* to companies’ forming a corporate group called “*Grupo Homsany*” (GH). As in the previous cases, the interest of the State was at stake because the creditor was the Panamanian National Bank, whose claim was presented through the *Dirección de Responsabilidad Patrimonial* (a department of the *Contraloría General de la República* (National Audit Office)). However, although the state was the claimant, the case was not directly against a corporate personality. Rather, the decision in this case was justified by a series of facts. This case is of interest because in order to determine CB’s liability, the Panamanian court considered a series of facts that had not been considered in previous cases. Firstly, the controlling shareholder was another company part of the

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<sup>437</sup> The Panamanian Author Francisco Ferreira in the conclusions of his paper “*Acción de Amparo, Confidencialidad y Levantamiento del Velo Corporativo*” established that the corporate veil will only be pierced in cases in which the corporate entity has been used to hide assets that are part of a judicial investigation regarding a criminal act that happened inside the territory of the Republic of Panama. Ferreira wrote his paper in 1996 and like the author Barsallos, he described the Panamanian *levantamiento del velo* in its early stage. Moreover, he describes this doctrine as limited to the circumstance already mentioned. See, Ferreira, F. *Acción de Amparo, Confidencialidad y Levantamiento del Velo Corporativo*. Editorial Portobelo. Panama. 1996

<sup>438</sup> See, *Sentencia de la Corte Suprema de Justicia de Panamá, Sala Tercera Contencioso Administrativo, de fecha 20 de diciembre de 1999*. (Ref. num. 199912)

group; secondly the fact that the Homsany family owned the shares of the companies' forming the group but moreover CB and companies part of GH had the same directors; thirdly, the facilities where CB practiced its business belonged to the Homsany family (who were shareholders and controllers of CB and GH); and lastly, the Homsany family used assets of CB as if they were the family's assets (the separation of personalities was not respected). Based on these facts, the court reached the conclusion that it was necessary to disregard the corporate personality in order to reach the persons (CB and Homsany Family) who had committed a fraudulent act and had sought to hide behind the corporate entity.

The *levantamiento del velo* is a relatively recent subject in Panama. The three cited precedents might be considered as the most relevant among the few cases regarding this subject. Indeed, the “*Diberor*” case and *Sentencia de 16 de febrero de 1996* have emphasised the fact that the corporate personality cannot be ignored without strong justification. The precedent established in the *Sentencia de 20 de diciembre de 1999*, I consider, expanded the grounds on which the Panamanian doctrine of *levantamiento del velo* can be applied. In this case, the Panamanian court faced an issue based on the use of the Panamanian corporate entity to structure a fraudulent scheme. Therefore, the Panamanian Court took much trouble to analyse this case methodically because the precedent established in the *Diberor* case did not apply. Factors such as the degree of influence of the shareholders over the company's decisions and the compliance with formalities were considered when determining whether or not to ignore the corporate entity. The court decided to ignore the corporate personality in order to prevent and prohibit the company's participation in part of a scheme to evade obligations.

These precedents serve as evidence that the Panamanian doctrine of *levantamiento del velo* is at an early stage and parameters for its application are only being gradually developed. Although there is much negative academic opinion regarding the application of the doctrine in Panama, it is suggested that the doctrine is in its infant stages of development and does have the potential to develop to meet the potential abuses of corporate personality.

#### 4.3.3 The *Levantamiento del Velo Corporativo* in Current Panamanian Statutory Law

Currently, in Panamanian company law there is not a statutory rule that directly addresses the disregard of the legal entity in Panama. Originally, the rules that composed the Panamanian legal framework for companies did not include an exception of the corporate personality. Furthermore, throughout the Twentieth Century no attempt was made to develop a statutory exception to the corporate veil in Panamanian company law. The previously mentioned rules that directly or indirectly produce the disregard of the legal entity in labour and administrative law are the closest to a statutory exception to the corporate personality in this jurisdiction.

The reason for not developing a statutory exception to the corporate personality can be supported by a fear of undermining the corporate personality and thus foregoing the benefits provided. Certainly, Panama benefits from the foreign investors who decide to use Panamanian *sociedades anónimas* to practice offshore operations, as well as from domestic investors who use the *sociedad anónima* as a means to engage in risky enterprises. However, the benefits that produce this type of business association have not completely blinded the Panamanian policy makers to the negative effects that produce the misuse of the corporate entity. Therefore, during the last decade Panamanian policy makers have considered the introduction of exceptions to the corporate personality.

It can be considered that Panamanian policy makers' intention has not been to directly attack the framework for companies; rather, the strategy has been to introduce exceptions to the corporate personality in other areas of law that may be affected by the corporate entity. A relevant example is the proposal to introduce an exception to the corporate personality in Panamanian Family law (in 2004, the *Anteproyecto de Ley número 030* was presented in the *Asamblea Nacional de Diputados*).<sup>439</sup> This proposal was intended to establish measures to prevent and punish the non-compliance of duties towards the family. This proposal consisted of modifying and introducing articles to the *Código de Familia y el Menor* (Family Law). Among the

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<sup>439</sup> *Anteproyecto de Ley núm. 030 “por el cual se adoptan medidas para prevenir y sancionar el incumplimiento de los deberes familiares”* proponente H.D. Jose I. Blandón, presentado en fecha 7 de septiembre de 2004 ante la Secretaría General de la Asamblea Legislativa (la presente Asamblea Nacional de Diputados).

proposed modifications was the introduction of a rule that allowed the judge the *levantamiento del velo corporativo* in cases where the corporate personality has been used to hide assets in order to avoid the payment of money owed as a pension. However, the proposal was not approved.

Certainly, the proposed rule to deal with the misuse of the corporate veil in the context of family law can also be justified on social and moral grounds. However, it is important to remember that the piercing of the corporate veil is a relatively recent subject in Panama and it can be considered as not being wholly understood by the Panamanian judiciary and academia. Therefore, a degree of rejection regarding any law proposal that aims to disregard the corporate personality in any area of law has been produced. As a personal observation, with the gradual development of this subject, the Panamanian academia and judiciary will understand the application of this remedy. Moreover, with the understanding of this subject, proposals to create an exception in areas such as family law will be properly drafted and accepted. As has been discussed throughout this thesis, there are areas of law, such as family and labour law, which involve interests that are vital for society, and which tend to overcome the concept of corporate personality.

#### **4.4 Influence of other Latin American Jurisdictions over Panama in the Context of Corporate Personality Issues**

The comparison of Latin American jurisdictions in Chapter Three supports my argument regarding the influence of legal tradition and economic development in the context of corporate personality issues. Indeed, Latin American countries that have dealt with the corporate personality are those with considerable economic development and the exceptions have been developed in a way compatible with the values that are pillars of the legal tradition followed by Latin American countries. Certainly, each of the Latin American jurisdictions under study has presented a different legal need. However, these jurisdictions follow a similar legal tradition and consequently their method to deal with corporate personality issues has been similar: introducing an exception to a statutory rule.

Throughout my thesis, the civil law inclination for positive law and the need of a statutory basis to ignore the corporate personality in a country with civil law tradition have been emphasised. Additionally, the reader's attention has been drawn to the fact that an exception to the corporate personality cannot be limited to a statute and requires a judge's ability to use judicial creativity. The civil law tradition tends to limit a judge's judicial creativity for the sake of legal certainty yet modern civil law has developed principles and concepts that aid to mitigate the strict nature of this legal tradition. In the context of corporate personality issues, the Latin American countries studied in this thesis have relied on traditional legal concepts such as *ultravires*, *abuso del derecho* and *fraude a la ley*, to provide a judge with the means to deal with corporate personality issues. Indeed, if a company has acted beyond its power or whether there has been an abuse of rights, a judge's ability to reason is required. By supplementing statutory exceptions with these concepts, Latin American judges have been provided with a basis to justify the use of legal reasoning.

Panama has not developed an exception to the corporate personality but the concurrence of corporate personality issues makes the introduction of an exception to the corporate entity likely. I consider that Panama, as a Latin American jurisdiction, may follow the same trend as other countries in the region; i.e. the development of a statutory exception. Moreover, the fact that other Latin American countries have used traditional legal concepts to provide a degree of judicial creativity supports my suggestion of using *sana critica* as a supplement for this exception.

Certainly, I have argued that the methods against the misuse of the corporate personality are developed individually by each jurisdiction. However, the structure on which this is developed in Latin America is similar, a statutory rule. The difference lies in the extent for the application of the rules contained in the statute and the tools provided for the judge to enforce the statute. In the next chapter, the facts that have motivated me to choose *sana critica*, instead of other traditional concepts already used by other jurisdictions, shall be addressed.

## Chapter Conclusion

The *sociedad anónima* is currently a pillar of the Panamanian economy. Panama developed the legal framework for *sociedades anónimas* in a way that is accessible for nationals and foreigners alike who want to trade under the benefits of legal personality and limited liability. Panamanian authorities, however, are aware of the potential of the *sociedad anónima* to be a device to practice illicit acts and fraudulent schemes. Therefore, the *levantamiento del velo* has been considered by Panamanian authorities as a means to combat the misuse of the corporate personality.

Panama gives the impression of being a jurisdiction that is pro-corporate personality. However, the fact that corporate personality issues are relatively recent in Panama cannot be omitted. Panamanian authorities are aware that the corporate personality cannot be absolute. Evidence of this fact lies in the gradual introduction of the *levantamiento del velo* in Panama. The fact that the *levantamiento del velo* is a subject that has gained relevance proves that this jurisdiction is balanced in regard to the application of this remedy. Moreover, since the introduction of this remedy in 1991, the scope for its application has been gradually expanded and Panamanian policy makers have considered the introduction of this action in certain statutes to address specific circumstances.

In Panama traditional civil law concepts have not been used to deal with corporate veil issues. However, this does not mean that traditional legal concepts cannot be considered. Differing from the civil law jurisdictions studied in Chapter Three, in Panama the piercing of the corporate veil is not only recent in practice but also a recent topic also among academia. Therefore, there is a probability that with the development of this subject, academics may propose to implement a traditional legal concept as the basis for a statutory exception to the corporate veil in Panama. Indeed, it is likely that Panama follows the trend of the Latin American countries studied in Chapter Three not only because of the historical connection that the legal framework of Latin American countries have, but also because a statutory exception is more compatible with the nature of the civil law tradition.

## **CHAPTER V: The rules of *Sana Critica*: a set of rules that can Supplement an Approach to Apply the *Levantamiento del Velo* in Panama**

This chapter is the last but not least of this thesis. This chapter will develop the question on which this research has been founded; to what extent the Hispano-American principle of *sana critica* can supplement an approach to pierce the corporate veil in a civil law jurisdiction such as Panama?

In the previous chapters, general aspects of piercing of the corporate veil, together with the application of this remedy in Anglo-American jurisdictions, Spain and Latin American countries, were addressed. In addition, throughout this thesis it has been explained that the legal tradition followed by a country has been a factor that has had a heavy influence over the application of this remedy. On the one hand, the common law tradition allows judges the judicial creativity in order to deal with issues not covered by positive law or cases where the application of positive law might produce an unfair result. On the other hand, the civil law tradition strictly requires the civil law judge to apply positive law. This factor not only limits a judge's judicial creativity but also limits his capacity of interpretation. Based on this difference, both legal traditions have relied on a different method to deal with corporate veil issues; common law jurisdictions rely mainly on doctrine, while civil law jurisdictions rely mainly on a statutory rule based on traditional legal concepts.

It has been observed in previous chapters that doctrinal and statutory approaches present advantages and disadvantages in this context. However, the fact that civil law jurisdictions tend to rely on a statutory approach does not affect the application of a remedy such as piercing of the corporate veil. Rather, in this thesis, it is considered that the strict adherence to statutory law is the factor that interferes with the application of this remedy in a civil law country like Panama. The piercing of the corporate veil is not just the simple application of a statutory rule; it is a remedy that depends on legal reasoning being correctly applied. Corporate personality cases involve a different set of circumstances which make the judge question whether the

situation established in the statute has concurred or not. Consequently, the judge's ability to analyse and interpret the law cannot be completely restricted. Therefore, in this chapter, the use of the rules on which is founded the principle of *sana critica* as a means to supplement an approach to pierce the corporate veil in a civil law jurisdiction such as Panama is suggested.

My interest in the principle of *sana critica* lies in the English concept of equity. During my studies regarding piercing the corporate veil in Anglo-American jurisdictions, my attention has been drawn to the fact that some common-law judges have justified their decisions on grounds of equity. This fact led me ask whether the civil law tradition has an equivalent concept. In my search for an equivalent, I have found the principle of *sana critica*. As will be explained in this chapter, *sana critica* is not the same as the English concept of equity. However, *sana critica* and equity shares a similar objective, to render the administration of justice more flexible.

*Sana critica* is a principle that is currently used to aid the judge on the evaluation of evidence and facts. However, in this chapter it is argued that *sana critica* is something more than a tool to deal with the probatory aspects of the process. *Sana critica* is founded on a set of rules aimed at encouraging and guiding reasoning. These rules are logic, experience, proven knowledge and justification. In this chapter, this set of rules is addressed as "rules of critical thinking" and it is argued that these rules can supplement an approach to deal with corporate veil issues.

I begin this chapter by properly addressing the concept of *sana critica*, its origins and current use. Following this, I will explain how "the rules of critical thinking" can be used to deal with corporate personality issues; each rule shall be addressed. Lastly, I will draw the reader's attention to the rules of critical thinking as part of an approach to deal with corporate veil issues in Panama.

## 5.1 The Procedural Principle of *Sana Critica*

The concept of *sana critica* refers to a set of rules that encourage critical thinking and guide legal reasoning. The Argentinean jurist, Hugo Alsina, defined *sana critica* as “the rules based on logic and derived from experience”.<sup>440</sup> The Uruguayan jurist, Couture, defined *sana critica* as “the rules of human understanding”.<sup>441</sup> Definitely, this can be regarded as a concept related to reasoning. However, currently the concept of *sana critica* is used by Ibero-American jurisdictions to address a system to assess evidence and facts.<sup>442</sup> The reason to introduce this chapter by stating *sana critica* as being a procedural principle is because this is the name of one of the principles on which Ibero-American civil procedural law has been founded.<sup>443</sup> However, *sana critica* is more than a procedural principle. In this thesis, the rules that are the foundation of *sana critica* are regarded as a means to encourage the use of reason rather than the mechanical application of the law. This is a subject addressed in the second section of this chapter. In this first section, the general aspects of *sana critica* will be addressed.

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<sup>440</sup> See, Alsina, H. *Tratado Teorico Practico de Derecho Civil y Comercial*. Buenos Aires: Ediar S.A.; 1956. At page 127

<sup>441</sup> See, Couture, E. *Estudio de Derecho Procesal Civil*. Buenos Aires: Ediciones de Palma; 1979. At page 195

<sup>442</sup> The author Joel Castillo in his paper “*La fundamentación de las sentencias y la sana crítica*” quotes definitions of *sana critica* drafted by the authors Hugo Alsina (*Tratado Teórico Práctico de Derecho Procesal Civil y Comercial*, Buenos Aires, Ediar S.A Editores 1956) and Eduardo Couture (*Estudios de Derecho Procesal Civil*, Buenos Aires, Ediciones Depalma 1979) both recognized civil law academics. The short definition of *sana critica* I have provided is based on my understanding of Castillos’ analysis over the concept of *sana critica*. See, Castillo, J. *La Fundamentación de las Sentencias y la Sana Crítica*. *Revista Chilena de Derecho*. (Volume 33) 2006. At page 95 See also, Fabrega, J. *Procesos Civiles*. first edition. Panama: Editorial Juridica Panameña; 1999.

<sup>443</sup> Civil procedural law is founded in twenty one principles. Some of these principles are *igualdad de las partes* (equity among the parties) *principio de economia procesal* (procedural efficiency) *Principio de cosa juzgada* (principle of no retrial). The purpose of this footnote is not to engage on explaining each principle because are not part of my research. However, to point out the existence of these principles in Ibero-American civil procedural law gives an insight to the reader who is not familiar with this subject. For further information see, Chioyenda G. *Instituciones de Derecho Procesal Civil, Volumen 2*. Argentina: Valleta Editions; 2005.

### 5.1.1 Origins of the Principle of *Sana Critica* and its Introduction in Latin American Countries

The origins of this principle can be traced back to Spain in the year 1855 with the enactment of “*La Ley de Enjuiciamiento Civil Español*” (Spanish Civil Procedural Law).<sup>444</sup> This law, in its Article 317, established “Judges will use the rules of *sana critica* to assess the validity of a statement made by a witness”.<sup>445</sup> The rationale behind the enactment of this Article was to provide the judge with the ability to critically assess both the witness and the elements that influenced his/her statement (such as mental capacity and relationship between the witness and the parties). The ability of the civil law judge to use critical thinking was almost restricted in medieval civil law. The introduction of *sana critica* in Spanish civil procedural law was the product of the intellectual revolution that had taken place during the Nineteenth Century. This was a period of intellectual enlightenment in which scientific, logical and technical principles were applied in different areas of study.<sup>446</sup> During this period judicial reasoning was encouraged in opposition to the erroneous conception concerning the mechanical application of law, which was present at the time in the civil law tradition.<sup>447</sup> Medieval civil law was full of inconsistencies.<sup>448</sup> Thus, intellectuals such as Cesar Becaria identified the rudimentary practices of medieval civil law which in turn triggered the process of reform. It is important to add that

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<sup>444</sup> See, Hincapie, E. and Ramirez, J. *El Sistema de Valoración de la Prueba Denominado la Sana Critica y su Relación con el Estándar mas allá de la Duda Razonable Aplicado al Proceso Penal Colombiano*. Universidad EAFIT. 2009. Available at [http://repository.eafit.edu.co/bitstream/10784/436/1/Elizabeth\\_HincapieHincapie\\_2009.pdf](http://repository.eafit.edu.co/bitstream/10784/436/1/Elizabeth_HincapieHincapie_2009.pdf) [last visit may 30, 2013] At page 27

<sup>445</sup> “*Los Jueces y tribunales apreciaran, según las reglas de la sana critica, la fuerza probatoria de las declaraciones de los testigos.*” This article from the *La Ley de Enjuiciamiento Civil Español*, is cited by the profesor Boris Barrios Gonzales in his paper “*Teoria de la Sana Critica*” at page 5. Available at [http://www.academiadederecho.org/upload/biblio/contenidos/Teoria\\_de\\_la\\_sana\\_critica\\_Boris\\_Barrios.pdf](http://www.academiadederecho.org/upload/biblio/contenidos/Teoria_de_la_sana_critica_Boris_Barrios.pdf) [last visit may 30, 2013]

<sup>446</sup> *Idem*. At page 27

<sup>447</sup> The civil law tradition follows the strict application of statutory law and judges have little room for judicial creativity, a factor that in some circumstances has produced unfair decisions. The imperfection of this legal tradition was a determinant factor in the development of principles such as *sana critica* See, Inguza, B. *La Sentencia Arbitraria por Falta de Motivacion en los Hechos y el Derecho*. Universidad San Martin de Porres. 2010. Available at [http://www.uigv.edu.pe/facultades/derecho/documentos/biblioteca/Articulo03\\_BeatrizFranciskovic.pdf](http://www.uigv.edu.pe/facultades/derecho/documentos/biblioteca/Articulo03_BeatrizFranciskovic.pdf) [last visit may 30, 2013] At page 6

<sup>448</sup> During the Middle Age the legal system followed by Europe was based on Roman civil law compiled in the Justinian *Corpus Juris Civilis* and Cannonic law, and was addressed as *Jus Commune*. See, Perdomo, R. and Marryman, J. *Supra note 17*. At page 10

English common law was also influenced by the Nineteenth Century wave of enlightenment and development. English common law had flaws as did civil continental law. In England, medieval common law was full of undeveloped practices and its rigid application produced unfairness.<sup>449</sup> This was the reason for the creation of the Chancery Courts (also known as Courts of Equity), which became a means to mitigate unfair decisions made under the common law.<sup>450</sup> However, the Chancery Courts gradually gained relevance to the point when they became a parallel system with the common law. Lawyers and academics considered the two systems as inadequate, thus Chancery Courts were merged with common law through the Judicature Act in 1870.

While European countries were experiencing this period of intellectual enlightenment, Spain was gradually losing its influence over its colonies in America and different separatist movements had taken place throughout the region. Consequently, new republics were born. Certainly, Latin American countries became politically and economically independent from Spain. However, these new Republics lacked a legal framework. Therefore, Spanish colonial law was still applicable in the new Latin American Republics. During the colonial period, two bodies of law,

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<sup>449</sup> For example, regarding the legal proceedings medieval English law relied on the “Forms of action”. The form of action consisted of a determined proceeding for a determined circumstance. The affected party had to purchase a writ from the king’s chancery. There were different writs for different types of dispute and the proceedings were governed by the chosen writ; for example there was a writ aimed at dealing with trespass. However, trespass is a wide subject. Therefore, this writ had the categories of land, chattels and person. This made proceedings a burdensome task because there was no procedural uniformity; type of trial and concepts varied depending of the writ. Therefore during the nineteenth century an attempt at rendering uniformity led to the abolishment of most actions as distinct procedures. The Uniformity of Process Act 1832 and Common Law Procedure Act 1852 were some of acts in which these changes were included. See, Baker, J. **An Introduction to English Legal History**. 3<sup>rd</sup> Edition. U.K: Butterworths; 1990. At page 63-83

<sup>450</sup> By the 13<sup>th</sup> century, common law rules and doctrines were at an early stage. Early on, this system developed into a rigid, circumscribed set of procedures and remedies applied according to inflexible, technical rules. As a consequence people, dissatisfied with the remedy available to them, could choose to complain about the fairness of the decision with a plea for the king’s relief. The king had the power to vary the operation of the system of justice and to handle these pleas the king delegated a royal official called the Chancellor. The increase of these pleas and the development of rules and procedures led to the creation of chancery or equity courts. The court of chancery was a prerogative jurisdiction in which a Lord Chancellor appointed by the king made the hearings. By the 16<sup>th</sup> century, the appointed Chancellors became lawyers, and records of proceedings in chancery courts were kept. Consequently, a body of precedent that supported equitable doctrines was developed, and above all, equity courts started to compete with common law courts. However, the rationale of equity courts was lost during the coming years. Equity courts provided an option to rigid and inconsistent positive law by providing a solution through exercise of the logic, experience and conscience. However, throughout the years the organisation of equity courts and accumulation of precedents made this a complete body of law. See, Perdomo, R. & Marryman, J. *Supra note 17*. At page 49

addressed as the *Siete Partidas* and the *Ordenanzas de Bilbao*, were applied in the Spanish Colonies.<sup>451</sup> A bond between Spain and its former colonies was maintained by the fact that Latin American countries kept colonial law.

By the mid Nineteenth Century colonial law was not a body of law compatible with the economic and institutional changes of the period. Thus, the draft of new codes was a response to the legal, social and economic needs of the countries in the region. However, despite Latin American countries having enacted codes suitable to their legal needs, the codes were still influenced by developments in Spain.<sup>452</sup> The above mentioned *Ley de Enjuiciamiento Civil Español* was one of the main legal instruments used by Latin American countries as a guide for the development of their civil procedural law. Moreover, innovations introduced in this law, such as the principle of *sana critica*, were adopted by Latin American countries.

Chile was the pioneer in the development of a regulation similar to the *Ley de Enjuiciamiento Civil Español*.<sup>453</sup> Other Latin American countries took the Chilean work of codification as a reference. An example is Colombia who, based on Spanish and Chilean regulations, drafted the *Código de Cundinamarca*, which was to become an early civil procedural law borrowed by Panama.<sup>454</sup> It is important to add that after becoming independent, Colombia was the head of a confederation of countries called *Nueva Granada*.<sup>455</sup> My case study, Panama, was part of this confederation and consequently was influenced by Colombian codes. By 1903, due to political differences, Panama separated from Colombia and became an independent Republic. During the early days of the Republic, authorities had to rely on Colombian law until

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<sup>451</sup> The *Siete Partidas* was a Spanish statute drafted during the medieval period. It has been considered one of the most important works of codification since the Justinian *Corpus Juris Civilis*. The *Ordenanzas de Bilbao* is a commercial regulation that was developed due to the increase of colonies and trade and demand for a proper commercial legal framework. The *Siete Partidas* and the *Ordenanzas de Bilbao* were the laws applicable in Spanish colonies. These were the most important bodies of law during the colonial period from 16<sup>th</sup> to early 19<sup>th</sup> century. The *Siete Partidas* and *Ordenanzas de Bilbao* regulated aspects such as the regime for contracts and business associations. See, Mirow, M. **Latin America Law: A History of Private law and Institutions in Spanish America**. Texas: University of Texas Press; 2004. At page 75

<sup>452</sup> *Idem*. At page 160

<sup>453</sup> See, Fabrega, J. *Instituciones de Derecho Procesal Civil* § TOMO I. Panama: Editora Juridica Panameña; 2004. At page 26-27

<sup>454</sup> *Ibid*

<sup>455</sup> The Granadine Confederation was a federal republic that comprised Colombia, Panama and Northwest of Brazil. See, LaRosa, M. & Mejia, G. **Colombia: a Concise Contemporary**. U.K. Rwoman & Littlefield Publishers, Inc.; 2012.

the Panamanian Codes were enacted between 1916 and 1919. The Panamanian Codes, especially the civil procedural code, can be considered as having been heavily influenced by Spanish, Colombian and Chilean law. As a result, legal institutions are shared among these countries.

In the early days of modern Ibero-American jurisdiction, *sana critica* had a limited role. However, with the later development of modern procedural legislation, *sana critica* became the main means for the assessment of proof in Ibero-American jurisdictions.<sup>456</sup> Moreover, the use of the principle of *sana critica* has not been limited to civil procedural law but has also been expanded to criminal procedural law and labour law proceedings in some jurisdictions; for example, Panama and Chile. The Panamanian Code of Criminal Proceedings establishes in its Article 380 that the judge will evaluate facts of the case based on *sana critica*.<sup>457</sup> The Chilean labour code in its Article 456 established that the Court would assess the proof and facts in accordance with the rules of *sana critica*.<sup>458</sup> Indeed, the principle of *sana critica* is currently widely accepted by modern Ibero-American procedural law.

In Panama, not only the Panamanian positive law but also the Panamanian Supreme Court has embraced *sana critica* as a tool for interpretation of law and facts. The Panamanian Supreme Court, like other Hispano-American courts, has evaluated aspects of the civil law tradition that are not compatible with the modern administration of justice, such as the restriction of judicial creativity. Evidence of this statement is the *Sentencia de 13 de Septiembre de 1984* in which the Panamanian Supreme Court regarded the tendency of rigidly interpreting law as “out-of-date”. The Supreme Court in this *Sentencia* strongly recommended the application of and adherence to *sana critica*, a more suitable principle.<sup>459</sup> It is addressed as a more

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<sup>456</sup> See, Fabrega, P. *Diccionario de Derecho Procesal*. Colombia: Plaza & Janes Editores; 2004.

<sup>457</sup> Art. 380 “Los jueces apreciarán cada uno de los elementos de prueba de acuerdo con la *sana critica*...” See, *Código Procesal Penal de Panamá*. Asamblea Nacional. República de Panamá

<sup>458</sup> Art. 456 “Los tribunales valorarán la prueba basados en la regla de la *sana critica*” See, *Código de Trabajo*, Dirección Nacional de Trabajo. Gobierno de Chile.

<sup>459</sup> “En nuestro sistema de tarifa legal el dicho de los testigos hábiles y contestes hace plena prueba y lleva al juzgador irremediamente a la convicción mediante un sistema aritmético, de sumas o de restas, pero es precisamente en las circunstancias que ahora se resuelven en que el juez puede desatarse de ese antiguo sistema de valoración que constituye un fósil jurídico, para sin estar atado a la rigidez de la prueba legal ni a la excesiva incertidumbre de la libre convicción, aplicar la fórmula que más se aviene con la nueva doctrina en materia de valorización de pruebas que es la *sana crítica* por cuanto en esta se integran las reglas del correcto entendimiento humano basado en la lógica y la

suitable principle as it allows the judge to interpret the law and facts from a less restricted perspective. Definitely, the principle of *sana critica*, since its development in Spanish law and its introduction in Ibero-American jurisdictions in the Nineteenth Century, has become the backbone of modern procedural law. The objective behind the acceptance of *sana critica* in jurisdictions such as Panama has been to make the administration of justice less mechanical.

### 5.1.2 The Objective of *Sana Critica*

Originally, the probatory aspects of the legal proceedings were governed by the principle of *prueba tasada*.<sup>460</sup> Under this principle, the legislator pre-established the way in which judges must assess evidence and facts.<sup>461</sup> The principle of *prueba tasada* undeniably limits the logical reasoning of the judge and his ability to interpret the facts of the case. Consequently, this principle can be considered as being incompatible with the nature of the action to provide a judicial decision; such depends on the judge's reasoning.

Certainly the legislator should establish the proper means by which to obtain the proof and furthermore, what could be considered as licit or illicit proof in order to provide guidance and prevent abuse.<sup>462</sup> However, it can be considered that the

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*experiencia del juez.” See, Sentencia de 13 de Septiembre de 1984, de la Sala I Civil de la Corte Suprema de Justicia.*

<sup>460</sup> See, Arauz, H. *Fundamentos de la Prueba Judicial*. Panama: Universal Books; 2006. At page 68

<sup>461</sup> The principle of *prueba tasada* can be linked to the civil law tradition notion about the creation and administration of law: the legislator has the power to make the law and the judge is strictly limited to applying the law. See, Fabrega, P. *Supra* note 456.

<sup>462</sup> In order to prevent abuse, limits have to be established regarding the means used to obtain evidence. Rights such as privacy of domicile and correspondence cannot be ignored because these rights are protected by constitutions, international conventions and treaties. It may be argued that in the interest of justice and to comply with public policy, these rights must be ignored. Whilst interest of justice and public policy make a strong argument, to allow the easy disregard of the right to privacy will produce a chain of abuse. In order to prevent violation of privacy and other rights, legislators in different jurisdictions have established mechanisms to obtain proof without affecting any personal right; for example, a company as a person with rights is entitled to privacy. Thus, in order to confiscate documents regarding a company's finances, the public servant must request authorisation from a competent authority. If the public servant confiscates the documents without proper authorisation, the evidence obtained from the documents would be considered as illicit and therefore invalid. Moreover, the use of illicit proof may produce the suspension of proceedings. The effects of illegal proof have been explained in U.S and Latin American jurisdictions through the metaphor “**fruit from the poisonous tree**” (*doctrina del árbol envenenado*). Based on this metaphor, if the source of the proof (the tree) is poisonous, the fruit (the evidence) will be poison. Therefore, when applied, it will corrupt the proceedings. See, Midon, M. *Derecho Probatorio, Parte general*. Argentina: Ediciones Juridicas Cuyo; 2007. At page 267. See also, Garcia, E. *Eficacia de la Prueba Ilícita en el Proceso Penal ( a la Luz de la STS 81/98 de 2 de Abril)*. Valencia: Guarda Impresores S.L.; 2003. At page 75. See Also,

legislator cannot predetermine how the judge must assess the evidence. Every case involves a set of circumstances that make it unique. Although cases may be similar, there are aspects (such as type of offence, type of commercial relationship and the intentions of parties) that make a different assessment of the facts and evidence by the judge necessary. Therefore, the principle of *sana critica* was introduced to diminish the influence of the rigid principle of *prueba tasada*.<sup>463</sup>

*Sana critica* is a principle that provides authority to the judge to evaluate the facts and evidence from his own perspective rather than from that predetermined in law.<sup>464</sup> However, the principle of *sana critica* must not be confused nor regarded as something that confers absolute power to the judge, like the principle of *Libre Convicción*".<sup>465</sup> The principle of *libre convicción* is a principle part of the civil procedural rules consisting of the complete freedom of the judge to interpret facts and the evaluation of evidence.<sup>466</sup> This principle allows the judge, based on his own rational analysis, to decide over the matters without the need to justify the rationale of his decision.<sup>467</sup> Under *libre convicción*, the analysis of the judge is based on the ideologies and culture that have shaped his way of thinking. As a consequence, the judge may decide over a matter without a proper legal foundation and thus an arbitrary judgment may be produced. In a case involving a corporate entity, the judge may have a pro-corporate entity or an anti-corporate entity opinion. Consequently, allowing *libre convicción* may produce unjust and arbitrary judgments. The former will support the prevalence of the corporate entity over the affected party, whilst the latter will disregard the existence of the corporate entity without a solid argument. The principle of *Sana Critica* can be regarded as an intermediary between *libre convicción* and the previously explained *prueba tasada*. *Sana critica* stimulates the

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Mellifont, K. **Fruit of the Poisonous Tree: Evidence Derived from Illegally or Improperly Obtained Evidence**. Australia: Federation Press; 2009. At page 102

<sup>463</sup> See, Arauz, H. *Supra note 460*. At page 67

<sup>464</sup> See, Taruffo, B & others. *Consideraciones Sobre la Prueba y Motivación*. Fundación Coloquio Europeo Juridico. 2007. Available at [http://www.fcje.org.es/wp-content/uploads/file/Libros\\_Publicados/Cuadernos\\_Fundacion/CONSIDERACIONES\\_.pdf](http://www.fcje.org.es/wp-content/uploads/file/Libros_Publicados/Cuadernos_Fundacion/CONSIDERACIONES_.pdf) [last visit may 30, 2013] At Page 2

<sup>465</sup> See, Santas, C. *El Juez, la Prueba y el Delicado Arte de Juzgar*. *Revista de Opinión Juridica*. Available at <http://dialnet.unirioja.es/servlet/articulo?codigo=2192720> [last visit may 30, 2103]. At page 7

<sup>466</sup> See, Taruffo, B. & others. *Supra note 464*. At page 2

<sup>467</sup> *Ibid*

use of legal reasoning yet not to such an extreme that legal certainty may be affected.<sup>468</sup>

In summary, *sana critica* was developed as a principle aimed at the interpretation of facts and evaluation of evidence and Ibero-American jurisdictions have used this principle for this specific task. However, *sana critica* is composed of a series of rules (addressed in Section Two) that make this principle a potential tool not only for the interpretation of facts but also for the interpretation of law. The principle of *sana critica* has been explained to this point and described as a tool that has been used to deal with the probatory aspects of proceedings. In the next following sections of this Chapter it will be demonstrated that the components of *sana critica* make the principle a tool for the interpretation of law that can be used as a device to deal with corporate veil issues.

## **5.2 *Sana Critica* as a means of dealing with Corporate Veil Issues**

In the civil law tradition, the judge's ability to assess, from a critical perspective, the circumstances of the case and the applicable law, tends to be constrained. This is a fact that can be attributed to the tendency of civil law tradition to adhere to positive law for the sake of legal certainty. This tendency is definitely not compatible with the nature of a remedy such as piercing of the corporate veil, which depends on the judge's ability to reason.

Critical thinking is key in dealing with corporate veil issues. However, to create an approach that gives a similar degree of judicial creativity to that provided to common law judges is definitely incompatible with the civil law tradition. The common law judge has a high degree of judicial creativity that allows him not only to rely on critical thinking but also to contribute to the development of the law. The common law tradition allows the judge to participate in the process of law making.<sup>469</sup> The civil law judge, on the other hand, has only the ability to apply the law. Moreover, in the early days of civil law, the judge's capacity of interpretation was constrained.<sup>470</sup>

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<sup>468</sup> See, **Enciclopedia Juridica OMEBA** § TOMO XVIII. Mexico: Driskill S.A. Ed.; 1979. At page 655-657

<sup>469</sup> See, Perdomo, R. & Merryman, J. *Supra* note 17. At page 34- 38

<sup>470</sup> *Ibid*

Currently, in the modern civil law tradition, the civil law judge is allowed to interpret the law and a degree of critical thinking has concurred. An example of a means used to free the civil law judge's mind can be found in Spain, a jurisdiction that has permitted judges the ability to act on equity through statutory rules in certain circumstances.<sup>471</sup> The concept of equity consists of the ability to provide a solution to a controversy that cannot be solved through statutory law. As is explained in Chapter Three, Spanish equity differs from the common law rules of equity based on the fact that Spanish equity is not a set of principles and ethics. In Spain, the concept of equity describes a liberty that has been conferred to the Spanish judge to reach decisions beyond the boundaries of positive law. Allowing a civil law judge to make decisions from an equitable perspective clashes with the conservative nature of the civil law tradition, hence the facility to decide under this concept is limited to specific circumstances. An example of a circumstance where the exercise of equitable thinking is allowed is in the context of liability derived from negligence. In this context, liability cannot be predetermined in a statute because each case contains factors that mitigate or increase liability. Thus, in the Spanish Civil Code Article 1103 it is established that "liability arising from negligence is equally enforceable in the performance of all kinds of obligations; but may be moderated by the Courts on a case-by-case basis".<sup>472</sup> Certainly, there is no direct mention of the concept of equity but the fact that Courts are allowed to measure the extent of liability in this context evidences a detachment of the strict adherence to positive law.

Conferring the ability to decide from an equitable perspective is an option to deal with corporate veil issues. However, the ability to decide from an equitable perspective not only frees the judge from constraints of positive law, but also gives room for personal biases. Consequently, in this thesis, it is considered that the concept of equity is not adequate to deal with such a sensitive subject as the piercing of the corporate veil. A tool for the interpretation of law and facts, on the other hand, can be considered as more appropriate to supplement an approach to pierce the corporate veil

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<sup>471</sup> See, **Chapter Three**. At page 123-124

<sup>472</sup> *Article 1,103: "La responsabilidad que proceda de negligencia es igualmente exigible en el cumplimiento de toda clase de obligaciones; pero podrá moderarse por los Tribunales según los casos."*

in civil law tradition countries. This tool for interpretation can be found in the rules that support the principle of *sana critica*.

The proposed approach of *sana critica* should not be confused with an approach based “on grounds of English equity”. On the one hand, if the judge is allowed to decide from an equitable perspective, room for personal biases exists. Alternatively, the rules of *sana critica* establish parameters that must be followed by the judge when he/she exercises critical thinking, thus preventing arbitrariness and inconsistent judgments. Other Latin American jurisdictions have supplemented their statutory exceptions to the corporate personality with traditional concepts such as *ultravires* and *abuso del derecho*. Statutory exceptions have established that the corporate personality will be ignored when this is used as an improper purpose; to define what is improper in this context, the Courts in Latin American jurisdictions have used the aid of the mentioned concepts. A degree of judicial creativity is required to determine whether an act falls within the concept of *ultravires* or *abuso del derecho*. These concepts provide judicial creativity and simultaneously control biases because proper justification of the alleged unauthorised or abusive conduct is required. I consider the rules of *sana critica* provide similar advantages. Moreover, the rules of *sana critica* give a higher degree of certainty. I support this statement by the fact that rules of *sana critica* are rules that apply to general legal thinking and are not limited to a specific behavior such as *ultravires* and abusive conduct.

However, as has been mentioned before, Ibero-American jurisdictions have used *sana critica* as a means of addressing the action of critically evaluating proof and evidence. Consequently, the fact that the use of the concept of *sana critica* is currently limited to a specific task raises the following question: can the concept of *sana critica* be used as part of an approach to deal with corporate veil issues? *Sana critica* is known and used as a probatory principle in Ibero-American jurisdictions. However, the rules on which *sana critica* is founded cannot be reduced and limited to one specific task. These rules guide critical thinking in a legal context and can be considered as something applied by the judge in his/her daily activity. Therefore, an approach to deal with corporate veil issues supplemented by the rules of *sana critica* can most definitely be developed, but to solely use the concept of *sana critica* itself is not possible because it would create confusion. For that reason, an approach that is

based on the foundations of *sana critica* should be addressed under another heading that makes reference to the rules of *sana critica*; for example, the “rules of critical thinking”.

The “rules of critical thinking” as a tool for interpretation can complement an approach to deal with corporate veil issues by allowing the judge to evaluate the concurrence of facts, such as control of the company and concurrence of fraudulent behavior, from an analytical rather than mechanical point of view. Furthermore, personal biases can be prevented from interfering with the judge’s decision. In the following section, the set of rules that compose the “rules of critical thinking” will be addressed and explained in addition to the way in which these rules can free the mind of the judge and prevent arbitrariness.

#### 5.2.1 The foundations of *Sana Critica* or “Rules of Critical Thinking”

The judge as a arbitrator cannot fall on arbitrariness because he would be acting against his duty, which is the administration of justice. By administration of justice, I make reference to the action of providing a solution to a conflict of interest. Certainly, positive law presents the basis to solve a conflict of interests, but there are circumstances in which positive law cannot be mechanically applied because it would produce an inequitable result. Thus, the judge is required to apply critical thinking. The rules of critical thinking establish the parameters that the judge must work within when applying critical thinking in order to avoid arbitrariness. The line of “critical thinking” is founded on: logic, experience, scientifically proven knowledge and judgment justification.

##### 5.2.1.1 Rules of Logic

The judge is not free to think nor act based on his own bias since this would be an action based on personal notions of justice rather than *sana critica*.<sup>473</sup> An act based on *sana critica* consists of an operation based on logic or rules of reasoning. Thus, there are rules of logic that cannot be ignored by judges. By rules of logic to which I refer are the laws that guide reasoning; the law of identity, law of non-contradiction and law of excluded middle. These rules have their origin in Greek philosophy and as a

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<sup>473</sup> See. Arauz, H. *Supra note* 460. At page 95

part of a method aimed at establishing validity or invalidity of arguments are grouped under the heading of “Laws of Thought”.<sup>474</sup>

- Law of identity - this is the first of the laws of thought and emphasises the individuality conferred to things; “each thing is the same with itself and different from another”.<sup>475</sup> For example, the corporation is a business entity with capital divided in shares. The subject (the corporation) and the predicate (a business entity with capital divided in shares) are one; the law of identity prohibits addressing another subject with this predicate. If the judge treats the corporation as a limited liability company (LLC), he would be acting against the law of identity. The LLC is a business entity, but it cannot be asserted that its capital is divided in shares. The LLC has its capital structured differently.<sup>476</sup> The law of identity, I consider, contributes to the decision making process by preventing inconsistent decisions. Inconsistency is prevented because the judge is required to respect the identity of the subjects and objects throughout the decision making process. Returning to the previous example, when it comes to the corporation and the LLC, both are legal persons but with a different essence. Besides capital structure, there are other aspects (such as less formalism) that make the LLC predicate unique. The judge cannot address the LLC as a corporation since doing so would undermine the identity of the LLC and produce an inconsistent decision.
- Law of non-contradiction - this law makes reference to the fact that contradictory statements cannot, obviously, both be true at the same time.<sup>477</sup>  
An example is the following statement: the corporation and the shareholder

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<sup>474</sup> The laws of thought were firstly conceptualised by Aristotles as part of a method to determine the validity or invalidity of arguments. This method consisten in the analysis of the premises from which it is derived a conclusion.This is one of the basis of modern logic. See, Corcoran, J. **Aristotle’s Prior Analytics and Boole’s Laws of Thought**. *History and Philosophy of Logic* (issue 24) 2003. At page 26

<sup>475</sup> See, Politis, V. **Routledge Philosophy Guidebook to Aristotle and Metaphysics**. New York: Routledge; 2004. At page 64

<sup>476</sup> The LLC is a type of business association that has a different essence to that of the corporation. In Panama, for example, the capital of the LLC is not structured with shares but is structured with “*certificados de participacion*”. This is a document that cannot be transferred or handled as a share since it is subject to different formalities. Membership of a Panamanian LLC could be regarded as more exclusive. See, Fabrega, J. **Ley Panameña sobre Sociedades de Responsabilidad Limitada**. Panama: Sistema Juridico S.A.; 2010. At page 53

<sup>477</sup> See, Politis, V. *Supra note* 475. At page 64

are different persons but the corporation and the shareholder are the same person. Certainly, both predicates can be applied to the same subject (the corporation), but not at the same time because doing so would produce confusion. A court dealing with corporate personality issues cannot accept both statements. It has to state whether it will preserve the separate corporate personality or ignore it. The law of contradiction aids critical thinking because it emphasises the impossibility of contradictory thoughts. Like the law of identity, the law of non-contradiction is a foundation on which thoughts are built. Thus, when it comes to the administration of justice, the judge has to respect the law of non-contradiction in order to prevent inconsistent decisions. Returning to the previous example, in corporate personality cases the judge starts with the premise that the corporate entity is a separate entity from its shareholders. The judge cannot contradict this belief unless acceptable justification is provided. Throughout the proceedings, different elements will provide the basis upon which the judge will decide whether to accept this predicate or not.

- Law of excluded middle - this law supplements the law of non-contradiction. The law of excluded middle demonstrates that between two contradictory statements, there is not an intermediary option. This law establishes that only one of two arguments will prevail. There is no room for a third possibility; for example, the corporation and the shareholder are different persons yet the corporation and the shareholder are the same person. In corporate personality cases, the judge (based on the facts of the case) has to decide which of these predicates to accept. If a third option were accepted, uncertainty would be produced. By allowing a third option, the judge could enter into an argument that does not provide an answer to the question about whether to preserve or ignore the corporate personality. Like the law of identity and the law of non-contradiction, the law of excluded middle supplements the administration of justice by creating the basis for consistent arguments.

The laws of thought create a deterrent against erroneous and inconsistent legal arguments.<sup>478</sup> Indeed, judgments are a source of knowledge and as such, cannot be full of vagueness nor inconsistent arguments because this would undermine the process of administration of justice.

The fact that the civil law tradition relies mainly on statutory law does not mean that doctrine develop from case law is less important. Case law presents a judge's analysis of a law and this definitely provides judges with knowledge to deal with a determined matter. In the context of piercing of the corporate veil, this is a recent subject and case law is a key for the proper understanding of this subject in civil law countries. Therefore, the rules of logic referred to must be followed in order to create consistent precedents.

As a personal observation, I consider that Anglo-American judges have omitted the laws that constitute the rules of logic in decisions where the corporate personality has been ignored. Consequently, these decisions have been subject to criticism due to their inconsistencies. An example of this is the U.S case, *Sea Land Services Inc, v The Peper Source*, cited in Chapter Two.<sup>479</sup> In this case, the decision of the first instance court was reversed because there was not strong proof regarding the concurrence of fraud. Therefore, the plaintiff presented evidence that the defendant company was used as a device for tax evasion and the Court accepted this in order to fulfill the requirement of fraud and thus ignored the corporate personality. The case was based on a claim for breach of contract. However, its outcome was decided on tax evasion, a fact that had no relation to the original claim. I consider that in this case, the American Court omitted the law of excluded middle. Indeed, the case was a about breach of contract and the issue was based on whether the company was used as a device to frustrate the contract. By permitting the tax argument, the court allowed an alien element into the case. Indeed, there was concurrence of fraud in the context of tax but this was not related to the matter of discussion regarding the case *Sea Land Services Inc, v The Peper Source*. Consequently, this case cannot be considered as having been properly justified and is therefore not a reliable source of knowledge. Another example is the English case, *DHN Food Distributors v Tower Hamlets*

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<sup>478</sup> See, Inguza. *Supra note 447*. At page 15

<sup>479</sup> See, **Chapter Two**. At page 81

*London Borough Council*, also cited in Chapter Two.<sup>480</sup> The Court of Appeal decided to ignore the legal personality of the companies, which were part of the group and regard them as a unit for the purposes of receiving compensation. The decision was heavily influenced by the comments of Lord Denning who was considered to support the disregard of the legal entity. Lord Denning based his argument on the control that DHN had over the other companies and compared this group with the concept of partnership. The DHN decision has been the subject of criticism because the argument on which it was supported was not consistent and was considered to be based on Lord Denning's notion of justice. I consider that in this case, Lord Denning omitted the principle of identity. It is already believed that the corporate group is a cluster of companies that have a separate corporate personality, liabilities and rights. The fact that the companies' part of the group act under the direction of one company called the parent, does not undermine the individuality of each company part of the group. However, by comparing the concept of a corporate group with a partnership, the individuality of the former concept was undermined because a partnership is a form of business association with a different essence to that of the corporate entity.

The "rules of critical thinking" require the judge to follow the rules of logic to avoid arbitrary decisions. This is a characteristic which I personally believe makes the "rules of critical thinking" appropriate to supplement an approach to deal with corporate personality issues.

#### 5.2.1.2 Experience

A judicial decision cannot be considered as an "inactive premise", which can be given *a priori*.<sup>481</sup> Judgment is an engaging task that involves reasoning influenced by ideological, cultural and political matters that produce different conclusions concerning the matter discussed. In other words, the judge requires the experience he has gained and learned from his constant activity in Court in order to supplement a decision based on critical thinking.

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<sup>480</sup> See, **Chapter Two**. At page 52

<sup>481</sup> See, Taruffo B. *Supra note* 464. At page 1

Experience can be defined as the knowledge gained by a man from his daily activities and from the environment in which he exists. In the legal context, however, the role of experience must be addressed carefully. Extreme ideologies formed from experience cannot prevail over the reality of the case because this would produce arbitrary judgments. Rules of logic must be applied together with experience in order to avoid arbitrariness.

In the context of corporate personality, it is important to keep judges' ideas balanced in order to prevent judgments based on pro or anti corporate personality. In Panama, for example, commercial judges' perception and knowledge have been based on the fact that the corporate personality should not be disregarded because it may be damaging for the economy. On the other hand, in case law it has been established that the corporate personality cannot be allowed to be used for illicit purposes.<sup>482</sup> These two premises stimulate a balanced position regarding the Panamanian *levantamiento del velo*. Indeed, Panamanian judges have been provided with the notion that corporate personality has a degree of importance for society and will not be disregarded unless an illicit or fraudulent situation is present.

### 5.2.1.3 Scientifically Proved evidence

The knowledge acquired by the judge cannot be unsupported nor based on accidental or fortuitous facts.<sup>483</sup> Evidence and facts presented in the process and considered by the judge when developing his decision, must be supported and certified by an expert in the area.<sup>484</sup> It can be considered that the rule of “scientifically proved evidence” is not key to the decision about whether or not to pierce the corporate veil because it focuses mainly on the assessment of the elements used to charge or defend the defendant. In a corporate personality case, the plaintiff may collect evidence such as certified financial statements to prove that the company was under capitalised or that shareholders transferred assets. However, the judge will make his/her decision based not only on the evidence presented by the plaintiff, but also based on other facts such as what has been established in case law and whether

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<sup>482</sup> See **Chapter Four**. At page 174-177

<sup>483</sup> See, Salinas, F. *Que es la Sana Crítica? La Valoración Judicial del Dictamen Experto*. 2004. Available at <http://www.juecesdemocracia.es/publicaciones/revista/articulosinteres/ZUBIRI.pdf> [last visit may 30, 2013] At page 52

<sup>484</sup> *Ibid*

there has been a concurrence of fraud. In other words, the piercing of the corporate veil depends more on the judge's ability to reason. Hence, proper judicial training is so crucial. In jurisdictions where fresh law graduates are made judges may pose a challenge to the proper application of *sana critica*.

I consider the role of scientifically proven evidence has more relevance for the defendant. For example, imagine a construction company that cannot finish a project due to an increase in the cost of materials and it has not enough assets to cover the compensation for the affected parties. This company must provide legitimate proof that the rise in material cost has had a devastating effect on the project and they should also give certified accountability statements in order to prove that the funds of the company had been used in a legitimate way. Therefore, the disregard of the legal entity, which will then make the company's shareholders liable for the failed project, can accordingly be prevented. The defendant can mitigate the harsh effects of a judgment by properly justifying his acts.

The control of the legitimacy of evidence and the scientific methods that are used to prove the veracity of the facts are subjects that have gained more relevance throughout the years.<sup>485</sup> The increase in the use of scientific knowledge by the judiciary reduces the weaknesses of common sense to some degree, such as uncertainty and subjectivity. Furthermore, it reinforces confidence in the judiciary because the decision making process will be less affected by subjectivity. However, it does not prevent a judge's personal bias from interfering with a judicial decision. Evidence will provide the judge with necessary information. However, the collection of evidence is a systematic process that has to be followed for such evidence to be accepted. The way in which the judge will evaluate the presented evidence will depend on other factors.

#### 5.2.1.4 Judgment Justification

The judicial authority cannot rely on his/her authority to support his/her decision because that would be an arbitrary action. A justification of the facts must be provided to feed and shape decisions. However, it is important not to get an erroneous

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<sup>485</sup> See, Taruffo, B. *Supra note* 464. At Page 8

perception of the judgment justification. Certainly, an erroneous idea is to consider this justification as a sort of log or register about each piece of evidence and all facts studied by the judge. The justification of the judgment is a deeper process, which is divided in *Razones Explicativas* and *Razones Justificativas*.<sup>486</sup> The former makes reference to the psychological facts that motivate the judge to make his decision. The latter makes reference to the arguments that motivated the decision and show its adherence to the current legal framework.

The requirement for judges to justify their decisions not only prevents arbitrariness, but also allows the questioning of a judicial decision.<sup>487</sup> By presenting the motives for his/her judgment, the judge gives room to question and debate the decision. A judgment may have omitted a key regulation, which can be identified on the motives presented by the judge. Rather than negative, this can be considered as a positive aspect of the rule of judgment justification. By debating the rationale of a judgment, unclear points are clarified and guidance for future cases is established.

The requirement to present the motives that lead to a judgment can be regarded as key to the development of piercing the corporate veil in common and civil law jurisdictions. Definitely, the debate over the corporate personality has been triggered by the justification presented for decisions over controversial corporate personality cases. An example is the English case of *Salomon* (discussed in Chapter Two), which has involved an intense debate about the decisions made by the First Instance Court, the Court of Appeal and the House of Lords.<sup>488</sup>

I have to add that judgment justification is not an exclusive rule of *sana critica*. I consider that the principle of judgment justification is present in the civil law and common law courts. Justification is not just a guiding value of *Sana Critica* but of the judicial procedural system. It is necessary to have a degree of public control over judicial decisions in order to achieve credibility and enhance the image of the judicial system. In fact, this is a principle that can be regarded as having its roots in

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<sup>486</sup> See, *Idem*. At Page 37

<sup>487</sup> See, Barrios, B. *Teoria de la Sana Critica*. Available at <http://www.acemiadederecho.org/upload/biblio/contenidos/Teoria de la sana critica Boris Barrios .pdf> [last visit may 30, 2013] At page 3-10

<sup>488</sup> See, **Chapter Two**. At page 43-45

democracy.<sup>489</sup> Society confers great powers to the judiciary and the principle of justification represents a mode of external control over the judiciary.<sup>490</sup>

### **5.3 An Approach to Apply the *Levantamiento del Velo* in Panama**

In Chapter Four, the piercing of the corporate veil in Panama was addressed. In this jurisdiction, there is no direct exception to the corporate personality. However, in case law, Panamanian authorities have already addressed this subject. Certainly, in this thesis, reference has been made to the limitation of the civil law judge in regard to exercising critical thinking. However, in modern civil law, the judge has been allowed to critically assess the facts of the case in some circumstances. In Panama, in the few cases involving corporate entity issues, it can be noted that judges have adopted critical thinking to decide matters.

In the precedent that decided an *acción de amparo* (writ of *amparo*) presented by the law firm, Patton, Moreno & Asvat, foreign authorities suspected that the defendant company was being used for illicit purposes. Therefore, foreign authorities presented a claim in Panamanian Courts to obtain documents kept by the company's resident agent. However, the channels used to present the claim were not appropriate and furthermore, the Panamanian public functionaries dealing with the case did not have the authority to ignore the existence of the corporation as a person with rights. As a result, the lawyers of the defendant company presented an *acción de amparo*. They claimed that the company's constitutional right to privacy was violated and that there was an abuse of authority on the part of the public functionaries. Definitely, in this case, it can be considered that, aided by the rules of critical thinking, the judge decided the outcome. Based on the rule of experience, the judge developed his reasoning from the notion that "the corporate personality is preserved and will be ignored only in exceptional circumstances". Upon the basis of this notion, the judge had to assess critically whether the circumstances of the case were sufficient to justify the actions against the defendant company. The fact that the plaintiff did not follow the proper procedures and judicial authorities acted without proper authorization, created grounds for the Court to preserve the corporate personality and protect its

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<sup>489</sup> See, Inguza. *Supra note* 447. At page 37

<sup>490</sup> *Ibid*

rights. Moreover, the Court in this case followed the rule regarding justification by supporting its decision with the constitutional right to privacy and the fact that there was no justification to apply the *levantamiento del velo*.

The case, *Borzeti Inc.*, in which the Court had to determine whether a contractual obligation of a parent company could extend to its subsidiary, is another example of critical thinking in this context. In this case, the plaintiff wanted to enforce a judgment and requested a freezing injunction over the assets of a subsidiary. The plaintiff supported this action citing the dominance the parent company had over the subsidiary. Panamanian Courts, however, considered that the subsidiary was free from any liability because it was not a party in the contract subject of dispute. Moreover, the subsidiary complied with the necessary formalities for it to be considered an independent legal entity. Therefore, there were no exceptional circumstances that justified ignoring the corporate veil.

These are just some of the Panamanian cases on this subject. Unquestionably, it can be appreciated that authorities have exercised critical thinking to deal with corporate veil issues. However, in these cases, the Panamanian judges had the facility to exercise critical thinking due to the circumstances of each case. Indeed, to decide over a writ of *amparo* or a freezing injunction, the civil law judge is allowed to critically assess the facts which have triggered the action and thus determine whether they can be accepted or not. Nonetheless, no formal approach to deal with corporate veil issues has been developed from these precedents.

The existence of an approach to deal with corporate veil issues is linked to the prosperity of a country; this premise has been proved in this thesis. The fact that Panama currently enjoys a steady economic growth has produced circumstances such as the ones in the cited cases, which in turn have made the Panamanian judiciary question the existence of the corporate personality. This fact will definitely lead to the development of a consistent approach to deal with corporate veil issues.

### 5.3.1 The Basis of a Panamanian Approach to Deal with Corporate Veil Issues

The “rules of critical thinking”, as a tool for interpretation, can supplement an approach to deal with corporate veil issues in Panama. However, what sort of circumstances should a Panamanian approach evaluate in order to decide whether or not to ignore the corporate personality? In this thesis, it is considered that a Panamanian approach to deal with corporate veil issues ought to be based on the concurrence of control, fraud and causation. Unquestionably, these are the same judicial considerations evaluated by U.S. Courts when deciding a corporate veil issue on grounds of instrumentality or alter-ego doctrine. However, to suggest the use of these concepts in a Panamanian approach does not mean that Panama should blindly copy nor strictly follow the American doctrine. The concepts of control, fraud and causation have been organised by the American doctrine. However, these concepts cannot be considered as exclusive to the American doctrine; rather, these concepts can be regarded as universal.

The corporate personality and all its components are, in essence, the same. In regard to corporate veil issues, the control of the company, fraudulent intention and causation are circumstances that every court scrutinises (directly or indirectly) when considering whether or not to ignore the corporate personality. Indeed, statutory exceptions to the corporate personality, such as the ones established by Argentina and Brazil, provide that the corporate personality will be ignored when shareholders, based on their control over the entity, use the corporate personality fraudulently.<sup>491</sup> The concepts of fraud and control, however, have not been introduced “unrefinedly” in the Latin American jurisdictions studied in Chapter Three. Control and fraud are not easy to define in a statute, so statutes have used traditional legal concepts as a basis. In Chapter Three, the concepts commonly used in this area are defined; these are the concepts of *fraude a la ley*, *simulación*, *abuso del derecho* and *ultra-vires*.<sup>492</sup>

Panama, as a country that follows the civil law tradition, has to establish an approach that must be supported by statutory rules. Certainly, the concepts of control and fraud in the context of corporate personality are not easy to define in a statutory

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<sup>491</sup> See, **Chapter Three**. At page 157-160

<sup>492</sup> See, **Chapter Three**. At Page 114-116

rule. Therefore, another question arises: how can these concepts be adapted in a civil law country like Panama? The answer lies in traditional legal concepts and principles that already exist in the civil law tradition. The concepts of *fraude a la ley*, *simulación*, *abuso del derecho* and *ultra-vires* are concepts that exist in civil law traditions and have been adapted in order to be applied to deal with corporate veil issues. As shown in Chapter Three, Argentina, Colombia, Chile and Brazil have structured their approaches to deal with corporate veil issues over one of the aforementioned concepts. Nonetheless, each of these jurisdictions did not randomly decide upon the concept used as the basis for its statutory approach. Rather, a concept was chosen based on different facts, such as the use given to the corporate entity and the perception academics and judiciary have of the corporate entity.

In the case of Panama, concepts such as control and fraud must be drafted in accordance with the situation of the corporate personality in Panama. As I previously mention, the concept of corporate personality is universal but certain aspects of its structure and use tend to differ in each jurisdiction. Consequently, this may influence the definition of excessive control and fraudulent behaviour. In the case of Panama, the economy has a small equity market and consequently most Panamanian corporations are privately owned. As explained in Chapter Four, public companies are not common in this jurisdiction and thus requirements for incorporation are less strict.<sup>493</sup> In addition, Panama has developed as a financial service provider. Moreover, one of the main services provided by this country is the incorporation of offshore companies. Offshore companies are not only employed as an instrument to diminish the risks that are involved in a commercial venture but they also tend to be used as a means to protect assets. Therefore, Panamanian corporate entity can be considered as largely comprised of private and shell companies.

Based on the nature of the Panamanian corporation, the concepts *ultravires* and *abuso del derecho* should be discarded as the basis for a Panamanian approach to deal with corporate veil issues. Firstly, in Panama there is no impediment for a company to act beyond the objective established in its Memorandum of Association.<sup>494</sup> As an offshore service provider, Panama has to offer a flexible regulation for companies.

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<sup>493</sup> See, **Chapter Four**. At page 162-164

<sup>494</sup> See, *Ley* 32 de 1927 article 2

Requiring a company to modify the Memorandum of Association in order to act beyond the original objective is a burdensome process that can make Panama less competitive against other financial services providers. Secondly, the use of the corporate entity for offshore operations and business strategies involves practices that may be considered by other jurisdictions as abusive but are allowed by the Panamanian framework for companies. An example is the fact that the existence of shell companies is tolerated providing they comply with the minimum requirements established by Panamanian legislation.

The concepts of *simulación* and *fraude a la ley* are the most compatible with the nature of the Panamanian corporation. In fact, in Panamanian relevant precedents on this subject, Panamanian authorities evaluated conducts that fall within the scope of these concepts. In the *Diberor* case, the reasoning of the Courts led them to consider the use of the corporate entity as part of a simulated act to obstruct the process of administration of justice and defraud the law.<sup>495</sup> In the case involving the *Homsany Group*, the Court evaluated the aspects of the case in order to determine the existence of a simulated act aimed at achieving a fraudulent purpose.<sup>496</sup>

To rely on concepts such as *simulación* and *fraude a la ley* is the most appropriate means to deal with corporate veil issues in Latin American civil law countries. Indeed, the strict nature of the civil law tradition leads Latin American policy makers to use the tools already provided by civil law tradition and adapt these to corporate veil issues. The Latin American countries studied in this thesis have structured their exception to the corporate personality on traditional concepts. This is a trend that is likely to be followed by other countries in the region. The rationale for other jurisdictions to follow this trend lies in the fact that an exception built on these concepts is more compatible with the legal framework of Latin American civil law countries. The proposed “rules of critical thinking” can, I consider, supplement an approach based on traditional legal concepts, not only by encouraging critical thinking, but also by providing grounds for consistent decisions.

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<sup>495</sup> *Supra* note 426

<sup>496</sup> *Supra* note 438

## Chapter Conclusion

In this chapter, it has been noted that the piercing of the corporate veil cannot be mechanically applied; rather, it is a remedy that depends on judges' critical thinking. Certainly, the existence of the corporate personality and the legitimacy of the acts under the cover of this fiction create different premises and conclusions about whether or not to ignore it. In this chapter, it has been suggested that a statutory approach to deal with corporate veil issues in Panama should be based on judicial considerations such as excessive control over the company, fraud and causation. However, it was also pointed out that these concepts cannot be introduced "without refinement" because of the limitations of civil law judges' judicial creativity. Thus, the key to define and determine the concurrence of control and fraud in a Latin America civil law environment is found in civil law traditional concepts of *fraude a la ley*, *simulación*, *abuso del derecho* and *ultra-vires*. However, in this chapter, attention has been paid to the fact that the values of *sana critica* ("rules of critical thinking") are more suitable to supplement a statutory approach aimed at piercing of the corporate veil in Panama.

The "rules of critical thinking", in opposition to the mechanical application of the law, encourage the employment of rules of logic and experience. The rules of logic require the judge to follow principles that prevent wrongful and inconsistent reasoning; the concept of experience makes reference to the knowledge the judge has gained from his daily activity. Knowledge gained through experience involves the basis of a person's ideologies and thus may produce the concurrence of personal biases in the process of administration of justice. However the "rules of critical thinking" also require the judge to present the motives for his/her decision. By providing a judge's motive, the opportunity for the decision to be questioned is also given and thus errors on the interpretation of law, omission of principles and arbitrariness are prevented.

The piercing of the corporate veil is a remedy that each jurisdiction develops individually in accord to its legal needs. Panama, as a civil law jurisdiction, is likely to follow the trend followed by other civil law jurisdictions and that is to introduce a

statutory exception to the corporate personality. The suggestion of systematically applying the rules of critical thinking in this context can, I consider, make more efficient the application of this remedy. As commented throughout this thesis, the civil law tradition is cautious when it comes to judicial creativity. The “rules of critical thinking” can, I believe, create a balance between the conservative nature of the civil law tradition and the need for judicial creativity in the context of piercing the corporate veil.

## CONCLUSION

Throughout this thesis I have validated the premises on which my perception of piercing the corporate veil has been shaped. Firstly, economic prosperity is a factor that is definitely relevant for the existence of an approach to deal with corporate veil issues. Indisputably, the use of the corporate personality is more common in countries with considerable economic growth. Consequently, corporate personality issues are more probable in prosperous countries. Evidence of this lies in the region of Latin American, where not all countries have introduced an exception to the corporate personality due the lack of economic dynamism. This in turn makes the corporate personality unnecessary. The Latin American countries studied in this thesis (Argentina, Colombia, Brazil, Chile and Panama) are some of the few countries in the Latin American region that have introduced or at least considered an exception to the corporate personality. The Latin American countries subject of study have dynamic economies in which the corporate personality is a pillar for development and thus issues in this context have become more common.

In the case of Argentina, Colombia and Brazil, was introduced an exception to the corporate entity in a period in which each of these countries was experiencing to have more dynamic economies. With regard Chile and Panama, these countries have not introduced an exception to the corporate personality. However, these are economies with steady economic growth and the corporate personality has been a pillar in their current development. Consequently, authorities in these jurisdictions have considered the need of an exception to the corporate personality to counter the misuse of the corporate personality. In this thesis it has been demonstrated that economic prosperity produces a legal need in the context of the corporate personality.

The legal need produced by economic development has created circumstances for my second premise, which is based on the factors that influence the development of an exception to the corporate personality; namely legal tradition and politic-economic factors. In this thesis, I have referred to these factors as being the basis on which the

corporate personality and its exceptions are developed. Moreover, the legal tradition followed by a country, in addition to its internal political and economic factors, contributes to the uniqueness each jurisdiction has when dealing with corporate personality issues.

This thesis has emphasised that legal tradition establishes the principles and rules on which a country's legal framework is developed. In the context of the piercing of the corporate veil, an exception should be drafted in accord to the principles established by that particular jurisdiction's legal tradition.

Latin America is a region that follows the civil law tradition. Consequently, ignoring the corporate personality has been developed in accord to the principles established in this legal tradition. Under the civil law tradition, one of the most important values is the adherence to positive law. It is considered that legal certainty is achieved through the strict observance of positive law and thus there is no opportunity for judicial creativity since it is believed to undermine legal certainty. As a result, in Latin America any exceptions to the corporate personality have been developed in statutory law.

The fact that Latin American countries follow the same legal tradition does not mean that corporate veil issues are handled on similar grounds. Certainly, the Latin American countries that have introduced an exception to the corporate personality have done it through a statutory rule. Nonetheless, each of the jurisdictions addressed in this thesis has drafted (or is in the process of developing) a statutory exception to the corporate personality in accord to internal legal needs.

Internal legal needs are derived from political and economic factors. By political factors I make reference to the policies implemented by a government to deal with specific issues; for example, policies aimed at the protection of workers rights. Political factors most definitely influence the development of an exception to the corporate personality due to the interests that are at stake. Certainly, a policy may not be aimed at the corporate personality. However, the effects of the policy may collide with the concept of corporate personality. The concept of corporate personality is not absolute and the interests that are protected by a policy may motivate an exception to

the corporate personality. Additionally, in this thesis I have argued the capacity of some public policies to override the concept of corporate personality. In this thesis, I have addressed as public policies those that contain a collective or public interest that the State has the duty to protect; for example, in the context of criminal law the corporate personality is likely to lose validity when used as a vehicle for financial crimes since there is a collective interest regarding the prevention and punishment of such crimes and this has been enhanced by international conventions. Mainly in the context of public law, policies tend to prevail over the corporate personality due to the public interest that may be affected.

With regard to economic factors, it can be argued that they are the result of policies implemented to encourage economic growth; for example, the development of a flexible legal framework for companies. Certainly, economic prosperity triggers the common use of the corporate personality. However, each jurisdiction nonetheless adapts the corporate entity in accord to its own economic needs; an example being my case study Panama, an offshore financial centre that has adapted the concept of corporate personality in accord to its relating economic needs. Economic factors are significant because an exception to the corporate personality without considering economic factors would undermine the benefits provided by the corporate personality.

In the politic-economic factors lies the uniqueness of each jurisdiction in the context of corporate personality issues. Evidence has been provided not only in the comparative study of Latin American countries and Spain, but additionally in the comparison with Anglo-American jurisdictions. Each jurisdiction has individually addressed the subject of piercing the corporate veil and has established an exception in areas or circumstances where doing so would be required in order to support the enforcement of law.

It must be noted that the internal aspects that make piercing the corporate veil a subject that is addressed individually by each jurisdiction have produced exceptions that apply to other types of business associations. In some jurisdictions the joint stock corporation is subject to stricter regulation and formalities. Thus, instead of adopting a more flexible regulation for companies, other types of business association (*sociedad por acciones simplificadas* and Limited Liability Company) with similar

attributes but less rigorous regulation have been developed. The fact that other types of business associations have legal personality and provide limited liability triggers corporate personality issues. Consequently, the action of ignoring the corporate personality has also been aimed at these other types of business association. Definitely, in modern corporate law to talk about piercing of the corporate veil is not exclusive to the joint stock corporation.

The notion of piercing the corporate veil as an American doctrine that has been borrowed by other common law and civil law jurisdictions has been challenged in this thesis on grounds of the uniqueness that each jurisdiction has when dealing with corporate veil issues. In this thesis, I have presented and proved premises that support the uniqueness of each jurisdiction in this context (legal tradition and the need of law derived from political and economic factors). Moreover, by supporting my argument regarding the uniqueness of each jurisdiction I have justified my research question; each jurisdiction uses concepts and principles already provided by the legal tradition in order to supplement an exception to the corporate personality. I regard the preference for concepts or principles already provided by the legal tradition because the transplant of foreign concepts or principles may clash with principles established by the legal tradition. Current traditional legal concepts and legal principles are used in order to make the application of an exception to the corporate personality compatible not only with the legal framework for companies that each jurisdiction has, but also with the values on which the legal system has been structured.

My case study, Panama, as an offshore financial centre gives the impression of a pro-corporate personality jurisdiction. Certainly, as in other jurisdictions, in Panama the piercing of the corporate veil is a delicate subject because its uncontrolled application would undermine the benefits produced by the corporate personality. Nonetheless, the Panamanian Supreme Court has considered the subject of piercing the corporate veil in determined circumstances. Indeed, in this thesis I have cited case law in which the Panamanian Supreme Court demonstrates concern regarding the misuse of the Panamanian corporate personality. I have regarded this fact as grounds for the later draft of an exception to the corporate personality in this jurisdiction. I have supported this believe with the legal need created by the common use of the corporate personality.

Legal tradition, as I have demonstrated, is an influential factor. Therefore, the fact that Panama follows the civil law tradition makes the introduction of an exception to the corporate personality through statutory law more probable. Moreover, civil law traditional legal concepts or principles may supplement a statutory exception to the Panamanian corporate personality.

In this thesis, I have proposed the Hispano-American principle of *sana critica* to supplement an exception to the Panamanian corporate personality. I have considered the use of *sana critica* because it is a principle that allows a degree of judicial creativity, something which is absolutely necessary when dealing with corporate personality issues. In this thesis, I have emphasised that corporate personality issues present circumstances that cannot be summarised in a statutory rule. I have supported this belief with the nature of the corporate personality; i.e. to transfer the risk of an enterprise to creditors or a third party, a situation that provides opportunity to argue fraud and unfairness. Definitely, a company may default and its assets may not be enough for the creditors, yet no fraudulent intention by the part of the shareholders may exist. Thus, the corporate personality cannot be ignored by the mere allegation of fraud on grounds of a statutory rule because not only will the integrity of the corporate personality be affected, but also that of innocent parties. Corporate personality issues cannot be strictly addressed through a statutory rule. Judicial creativity is also required to measure whether the facts of the case fall under the rules contained in the statute. In this context, it is not easy to define what can be considered as fraud or unfairness. It is a question to be dealt with on grounds of judicial creativity. Certainly, judicial creativity is not widely applied in the civil law tradition. Nonetheless, in this thesis it has been demonstrated that the modern civil law tradition provides the means to apply judicial creativity when required.

Latin American jurisdictions studied and compared in this thesis have dealt with the limitation of a statutory rule by using traditional concepts such as *ultra-vires*, *fraude a la ley* and abuse of rights. The traditional legal concepts used by Latin American jurisdictions were not originally created to deal with corporate personality issues, but they have been successfully adapted to this context. It has been possible to adapt these concepts to deal with corporate personality issues not only because they

are a source of judicial creativity, but also they are concepts dealing with circumstances that can be applied to the corporate personality. Indeed, an argument against the corporate personality can be supported on grounds of non-authorised acts and fraudulent or abusive use of rights, as long as the facts of the case present the elements to prove these circumstances.

I have considered *sana critica* instead of other available concepts or principles because of the rules on which *sana critica* has been developed. The principle of *sana critica* is composed by a group of rules that in this thesis I have addressed as “rules of critical thinking”. They are rules that are aimed at guiding reasoning. The principle of *sana critica* was originally created as a means to reduce the rigid administration of justice by adapting the “rules of critical thinking” in a legal context. In other words, *sana critica* is a system to guide judges’ thinking and to prevent the concurrence of personal biases in judicial decisions. In this thesis, I have stated that *sana critica* can be adapted to deal with corporate personality issues. I have supported my statement on the fact that *sana critica* is not only a source of judicial creativity, but also a concept that tends to preserve legal certainty.

In this thesis, judicial creativity has been considered essential with regard to piercing the corporate veil. To deal with the corporate personality requires a judge’s ability to act beyond the boundaries of statutory law. I regard *sana critica* as a more suitable concept than others employed by some other Latin American jurisdictions due to the fact that ‘the rules of critical thinking’ are not limited to deal with a corporate personality issue from a perspective restricted to abuse or extra limitation of powers. Generally, the “rules of critical thinking” give the judge the ability to evaluate the corporate personality issues from a wider perspective. Certainly, in civil law tradition countries there is concern about the concurrence of personal biases should judicial creativity be allowed. However, the “rules of critical thinking” require the judge not only to decide based on rules of logic and experience, but also to present the motives and reasons for his decision. By requiring justification the occurrence of inconsistent decisions is reduced.

*Sana critica* can supplement a statutory exception to the Panamanian corporate personality. It is a concept that can be adapted to the Panamanian legal framework for

companies and furthermore respects the principles of the civil law tradition on which the Panamanian legal system has been developed.

## **Suggestions for Further Research**

The corporate veil issue in this thesis has been addressed in Ibero-American jurisdictions and Brazil. Latin America follows the civil law tradition, however, the way this region have dealt with corporate personality issues differs to that of other regions in the world, such as Northern-Europe. North-European countries follow the civil law tradition. Nonetheless, North-European countries have not dealt with the corporate personality issues as have Latin American countries. Indeed, Northern-Europe has had a different economic development and corporate personality was active in this region before it being so in Latin American countries. I consider that a study about piercing the corporate veil in Northern-European civil law countries will provide an insight about this subject in this region. This study can provide a wider ground for the development of future comparative studies regarding the piercing of the corporate veil in a civil law context.

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*Decreto de Gabinete 247 del de 16 de Julio de 1970, por el cual se crea la Comision Nacional de Valores, se Reglamenta la Venta de Acciones en la Republica de Panama y se Adoptan Medidas para los Accionistas Minoritarios*

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*Código de Trabajo de Panama Decreto de Gabinet 252(Publicado por la Series Legislativa. 1971- Pan. 1) Modificado por la Ley N° 44 de agosto de 1995).*

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