Bloomberg BNA

WORLD SECURITIES LAW REPORT >>>

News and analysis of securities law developments around the world.
For the latest updates, visit www.bna.com

International Information for International Business

Volume 18, Number 12 December 2012

English Law on Piercing the Corporate Veil Reconsidered in Light of Key Judgment

By Mark Dawkins, of Bingham McCutchen LLP, London.

In July this year the English Court of Appeal handed down its judgment in *VTB Capital PLC v. Nutritek International Corp and Others* ([2012] EWCA Civ 808). It is an important judgment, jointly written by the three appellate judges, who considered at length the current English law governing the circumstances in which the court will pierce the "corporate veil" and, more significantly, what remedies the court may go on to provide once the corporate veil is pierced. Although the court also addressed other questions concerning jurisdiction and the continuance of a worldwide freezing order, the commentary and conclusions concerning the corporate veil lie at the heart of the decision.

This article considers the broader context in which this decision has been handed down and examines the decision itself and how the law in this area may develop. It should be noted, at the outset, that although the Court of Appeal refused permission to appeal to the Supreme Court, the Supreme Court itself recently gave permission to appeal the decision and also agreed that the appeal should be expedited. Further developments in this area can, therefore, be expected in the coming months.

Commercial Fraud

Let us start with the broader context. The case concerns allegations of commercial fraud. I emphasize that these are mere allegations, since it seems that there have not been any material determinations of fact by the English court — the arguments have thus far proceeded on the assumption that the allegations by the claimant, VTB Capital, are true.

Many practitioners in the field of commercial fraud believe that this is a growth area, although it is not always clear whether this is because there is more commercial fraud about, or whether it is simply that more commercial fraud is being uncovered. I would suggest that it is more likely to be the latter. It can be said with some confidence that commercial fraudsters, and their victims, have existed ever since society has sought to engage in economic activity; and the English courts have been deciding cases in this area for centuries. Conversely, as all seasoned litigators know, commercial litigation of most varieties tends to follow a broad countercyclical pattern. This is because, as the economic tide of growth and prosperity recedes, all sorts of mistakes and wrongs are revealed; and, in less benign eco-

nomic times, businesses are more likely to seek redress for the consequences of those mistakes and wrongs.

Following the global financial crisis in 2007/2008, and the subsequent recessions in many economies, the tide has gone out a very long way indeed. Inevitably, this has revealed wrongdoing that might otherwise have remained concealed by rising asset prices, revenues and profitability. We should, therefore, expect there to be more claims involving, or at least alleging, fraud to be brought before the English courts; and that does indeed appear to be borne out by current experience.

Role of Commercial Court

How then are the English courts responding?

Many of the larger and more complex business cases are brought before the Commercial Court, which has positioned itself as one of the world's leading courts for the judicial determination of international business disputes. Its success in that regard is indicated by the fact that, at the present time, an astonishing 60 percent of the Commercial Court's caseload is estimated to involve litigants where one or more parties are from states in Central or Eastern Europe. Often, those parties have limited, if any, connection with England other than a business agreement with English law and jurisdiction provisions. Inevitably, a large number of these cases involve allegations of fraud or deceit. Less inevitably, but very interestingly, some of these cases are also challenging the extent to which (alleged) fraudsters use corporate vehicles in order to shelter themselves from the consequences of their wrongdoings.

This has provided the Commercial Court with opportunities at least to consider whether the existing law in this area should be developed or clarified. Arguably there are reasons why it should be: The use of special purpose corporate vehicles is widespread; and sometimes the "special purpose" for which such a vehicle has been formed seems to be to protect an individual from the consequences of his/her wrongdoing, rather than a more legitimate purpose, with the result that victims of commercial fraud risk being left without any effective remedy before the courts.

During 2011, Commercial Court Mr. Justice Burton handed down two judgments, both of which signaled a potential willingness to push the existing boundaries of law in order to provide the victims of commercial fraud with more effective remedies before the English courts.

Masri Case

The first decision was one of many in the well-publicized and long-running Masri litigation, in which the claimant, Munib Masri, was seeking to enforce judgments in a number of jurisdictions against two corporate entities. Having been frustrated at every turn, Masri's advisors launched fresh proceedings in England alleging a conspiracy on the part of the two corporate judgment debtors and a number of their controlling shareholders, who were individuals. The conspiracy alleged was, in essence, an agreement among the conspirators to pursue unlawful means to ensure that the assets of the judgment debtors (that is, the corporate entities) were put beyond the reach of Masri. Since the loss claimed was, in effect, the value of the unrecovered judgment debt, this conspiracy action promised to provide Masri with an effective means of going beyond the corporate vehicles, and attaching liability to the controlling minds of those vehicles.

Although the case only reached the stage of a jurisdictional hearing, Mr. Justice Burton was clearly willing to entertain the conspiracy argument and did not reject it out of hand: *Munib Masri v. Consolidated Contractors Company SAL and Others* ([2011] EWHC 1780 (Comm)). Not long after that decision, the litigation settled on confidential terms. The conspiracy argument has, therefore, not been subjected to full judicial consideration, but now that it has been used once, it is very likely to surface again.

Gramsci Case

The second decision by Mr. Justice Burton in 2011 was *Antonio Gramsci Shipping Corporation and Others v. Oleg Stepanovs* ([2011] EWHC 333 (Comm)). This case sowed the seeds for the Court of Appeal judgment in *VTB v. Nutritek*. In *Gramsci*, as with the *Masri* case referred to above, Mr. Justice Burton was essentially hearing preliminary questions about the jurisdiction of the English court. The underlying facts, as in *VTB v. Nutritek* which followed, were untested by the English court but, for the purposes of the hearing before Mr. Justice Burton, were assumed to be true. In summary, five individuals were alleged to have used sham corporate structures to divert the profits from a series of charter-parties, away from the claimants.

The claimants sought to pierce the corporate veil. Superficially, this was not too surprising on the assumed facts. There are authoritative decisions of the English court defining the circumstances in which the corporate veil should be pierced (for example, *Trustor AB v. Smallbone & Others* ([2001] 1 WLR 117); and, more recently, *Ben Hashem v. Ali Shayif* ([2008] EWHC 2380)). Essentially, the court will do so if a company structure is misused, as a device or façade to conceal the truth, thereby avoiding or concealing the wrongdoing of individuals.

However, this apparently simple statement conceals a number of underlying questions. For example:

- What if the company has a pre-existing, separate and/or entirely lawful purpose? In *Gramsci*, Mr. Justice Burton decided that this did not arise, and so he did not need to address it (although, in the *Ben Hashem* case cited above, the court held that the corporate veil could in principle be pierced where the corporate entity had an antecedent, legitimate purpose).

- Before deciding to pierce the corporate veil, must the court conclude that it is necessary to do so in order to ensure that the victim has an effective remedy? (In many cases where the corporate veil is in issue, the claimants may have alternative remedies against individual directors or shareholders, for example, in

   ISSN 1357-0889

tort.) Mr. Justice Burton did consider this question in *Gramsci,* and concluded that, at least for the purposes of pleading an arguable case, necessity is not an essential prerequisite to the pursuit of a claim seeking to pierce the corporate veil.

- How "wrong" must the wrongdoing be? Must it be a clear case of fraud involving dishonesty, or can the veil be pierced where the wrong involves some lesser impropriety, such as a breach of a contractual obligation? Although past authorities suggest the latter, the question does not appear to have been considered expressly, at least in recent times.

So, in *Gramsci*, the assumed facts seemed to meet the test for piercing the corporate veil. However, alongside that claim, and more controversially, the claimants invited the court to conclude it was at least arguable that, having pierced the corporate veil, the wrongdoing individuals should be held to be bound by the terms of the contracts that the sham company had entered into. In other words, adopting the shorthand used by some judges, the claimants wanted the puppeteers to be held liable as if they too had contracted alongside the puppet company. This was critical to the claimants' case on jurisdiction because, under the relevant charter-parties, the puppet companies had agreed to the jurisdiction of the English courts; and, as the puppet companies were just empty shells, the true targets of the litigation were the puppeteers. If the contractual jurisdiction clauses did not bite as against the puppeteers, the jurisdiction of the English court was questionable.

In a groundbreaking decision handed down in February 2011, Mr. Justice Burton held that it could be argued that the puppeteers were liable as contracting parties alongside the puppet company. On the face of it, this was a promising extension of the remedies available to the victims of commercial fraud. It was, however, to be very short-lived.

Facts of VTB Case

Within a matter of months, in November 2011, the first instance hearing of *VTB v. Nutritek* took place. Although the underlying facts in that case were, of course, completely different, the key issues before the court, and the reasons why they were before the court, were remarkably similar to those in *Gramsci.*

The facts, as noted above, have not yet been tested by the courts, and so what follows is an outline of what the first instance court assumed for the purposes of the issues before it, although, as the judge pointed out, the evidence to support these assumed facts is "incomplete, untested and in some respects highly controversial."

VTB is a bank, incorporated in England and controlled by a Moscow-headquartered parent. Nutritek is a BVI-incorporated company which owned and operated dairy businesses in Russia. Konstantin Malofeev is a Russian citizen who, VTB contends, beneficially owns and controls a private equity group, whose corporate structure includes entities known as Marshall Capital Holdings Limited (a BVI company, and the second defendant in the proceedings) and Marshall Capital Holdings LLC (a Russian company, and the third defendant). VTB further contends that, through this structure, Malofeev also ultimately controls Nutritek.

In 2007, Malofeev approached VTB to indicate that he was exploring a sale of Nutritek's dairy businesses and was interested to know if VTB would provide financing for the prospective purchaser. The idea was to present a package to that purchaser which included pre-arranged financing, for an amount in the region of U.S.$200 million. VTB expressed interest, negotiations ensued, eminent law firms were instructed and, in due course, VTB entered into a facility agreement with the purchaser of the dairy businesses, which was a Russian company called Russagroprom LLC, or "RAP." Under the facility, VTB agreed to lend U.S.$225 million to RAP, in order to finance RAP's purchase of the dairy businesses, ostensibly at arm's length.

By September 2008, the loan appears to have been fully drawn down. On November 24, 2008, RAP defaulted on an interest payment and has made no payments since. VTB enforced its security and discovered that this security, including the assets of the dairy businesses, is worth substantially less than the amounts lent under the facility. On further investigation, VTB concluded that RAP was also controlled by Malofeev; and that what was dressed up as an arm's length business sale was in fact no such thing. VTB, therefore, commenced proceedings in the English court claiming that it was defrauded of the unrecovered portion of the moneys lent under the facility by false representations, both as to the arm's length nature of the transaction and as to the value of the dairy businesses.

Key Issues in VTB Case

Thus, adopting again the terminology used above, we have (at least according to VTB's case) a puppet, RAP, and a puppeteer, Malofeev. And it is here that the similarities with *Gramsci* become apparent. The loan facility agreement (and an associated swap agreement) includes provisions giving the English court jurisdiction to resolve disputes. There would, therefore, be no real question over the ability of VTB to sue RAP in England; but this would be of no real benefit to VTB, as it was a corporate vehicle lacking the assets to satisfy any judgment that VTB might obtain. (Indeed, by the time VTB issued proceedings, it had taken control of RAP through the enforcement of its security.) It is to be assumed, therefore, that VTB perceived its best chance of making substantial recoveries to lie in the pursuit of a claim against the puppeteer, in this case alleged to be Malofeev. The jurisdiction of the English court over Malofeev would, however, appear to be questionable — unless Malofeev could be treated, as in *Gramsci*, as being party to the facility agreement, including its English jurisdiction clause.

So this became the foremost issue before Mr. Justice Arnold at the first instance hearing in November 2011. The issue arose in the context of challenges by Nutritek to the jurisdiction of the English court, and an application by VTB to continue a worldwide freezing order. At the same time, VTB sought leave to amend its claim to

argue that it should be allowed to pierce the corporate veil and to hold Malofeev, along with the two Marshall Capital companies referred to above, jointly and severally liable with RAP under the facility agreement.

As Mr. Justice Burton had done in *Gramsci*, Mr. Justice Arnold conducted a careful review of the cases in which the court has in the past decided to pierce the corporate veil, and, in particular, the relief given where the veil has been pierced. Having done so, he reached the opposite conclusion to Mr. Justice Burton, deciding that VTB's claim that Malofeev should be treated as party to the facility agreement was "unsustainable as a matter of law."

The judge gave a series of reasons to support this conclusion, but the nature of the relief sought by VTB was central to his thinking. He noted that, in those cases where the corporate veil has been pierced, the court has in the past only granted equitable remedies — such as specific performance, injunctions and restitution. He concluded that such remedies were distinguishable from, and provide no support for, a common law claim for damages arising from breach of contract. He reasoned also that, to hold the puppeteer liable under a contract entered into by the puppet, would be to ignore privity of contract. Mr. Justice Arnold was not prepared to do this.

Court of Appeal Judgment in VTB Case

VTB appealed and, as noted above, the Court of Appeal handed down its judgment in July this year. In their (jointly written) judgment, the three members of the Court of Appeal acknowledged that the issue before them was ". . . ultimately a narrow, although fundamental, one: it comes down to a question as to the consequences of a judicial determination that, in a particular case, the veil of incorporation ought to be pierced."

Unfortunately for VTB, the Court of Appeal essentially agreed with the reasoning of Mr. Justice Arnold and dismissed VTB's appeal. In doing so, the court expressly overruled the decision in *Gramsci* and commented as follows:

> VTB's submission amounts to the proposition that there is a principle of English law that a person can be held to be party to a contract when, assessed objectively, none of the undisputed parties to the contract, had any thought that he was, let alone an intention that he should be. In our judgment, to accede to VTB's submission would be to make a fundamental inroad into the basic principle of law that contracts are the result of a consensual arrangement between, and only between, those intending to be party to them.

The language used here, and elsewhere in the judgment, seems to shut the door firmly on the notion that English law should be extended so that a puppeteer can be held liable as a party to the contracts of the puppet. In some ways it is reassuring that the English court continues to respect and reinforce the principle, established in 1897 by the (truly seminal) House of Lords decision in *Salomon v. Salomon*, that a company is a "real thing" with an identity wholly separate from its members and directors. It is widely accepted that this decision provided the legal foundation for companies, and groups of companies, to become the principal vehicles through which business is conducted the world over.

On the other hand, the universal success of the corporate structure, and the widespread use of "special purpose" vehicles, sometimes established in inaccessible, offshore jurisdictions, mean that it is right for the courts to be asked, regularly, to review and examine the balance between the protection afforded to legitimate business persons by limited liability; and the risk that this same protection will enable the perpetrators of fraud to escape the consequences of their wrongdoing.

It seems that, before the Court of Appeal, VTB argued that it is important for English law to have the necessary tools to deal with commercial fraud. The Court of Appeal's response was that, in this particular case, those tools exist, as it was open to VTB to bring a claim against the puppeteers relying on the tort of deceit (although not before the English courts). In that respect, the Court of Appeal appears to have considered that necessity is an essential prerequisite, if not to piercing the corporate veil, then at least to any decision to extend the principles that apply to the consequences of a piercing.

One is left wondering, therefore, whether the Court of Appeal might have reached a different conclusion if no alternative remedy had been available; or, for example, if the alternative remedy would only be available in a jurisdiction where there was a substantial risk that justice would not be obtained.

As noted in the opening paragraphs of this article, the Supreme Court has given permission for leave to appeal to it. It remains to be seen what the Supreme Court decides. It would be foolhardy to make predictions, other than to observe that the courts generally have subscribed to the view that piercing the corporate veil is a tailored remedy that should only be extended incrementally. Thus, much will depend on whether the Supreme Court agrees with the Court of Appeal's view that the particular remedy sought by VTB is very far from being incremental, but would instead represent a "fundamental inroad" into a basic principle of law.

This restrictive, incremental view may, however, be contrasted with the broad, unlimited view that the courts take of fraud. Long ago, in the 18th century case *Earl of Chesterfield v Janssen*, the court observed that "fraud is infinite," and declined to define it absolutely, so as not to fetter its jurisdiction because, in the future, that definition would be ". . . eluded by new schemes which the fertility of man's invention would contrive.. . ." Might it be argued that, if the courts are prepared to recognize an infinite variety of frauds, they should be equally elastic in the remedies that they provide to the victims of those frauds?

Conclusion

To conclude, for the reasons that this article has touched upon, the resilience of the corporate veil, and the consequences of piercing it, are fundamentally important legal issues, with equally important business ramifications. On the one hand, they provide the bed-

   ISSN 1357-0889

rock upon which the vast majority of business interaction takes place, and on the other, when abused, they shelter the perpetrators of wrongdoing.

In today's business environment, the need for clarity and certainty in this area has never been greater. Special purpose vehicles are created with ease; it is customary for a great deal of international business to be channeled through offshore centers, often for tax or regulatory reasons; and with digital records, so much "due diligence" information can be made available, that it is sometimes difficult to sort the wheat from the chaff. In all these circumstances, the scope for a fraudster to obscure the illegitimate use of a corporate structure is likely to increase.

It is, therefore, to be welcomed that these issues will shortly be reviewed by the Supreme Court. And it is to be hoped that the Supreme Court will seize this rare opportunity to provide comprehensive guidance that reflects the realities of the modern business world.

The text of the Court of Appeal's judgment in VTB Capital PLC v. Nutritek International Corp and Others ([2012] EWCA Civ 808) can be accessed at http://www.bailii.org/ew/cases/EWCA/Civ/2012/808.html.

The text of the Commercial Court's judgment in Munib Masri v. Consolidated Contractors Company SAL and Others ([2011] EWHC 1780 (Comm)) can be accessed at http://www.bailii.org/ew/cases/EWHC/Comm/2011/1780.html.

The text of the Commercial Court's judgment in Antonio Gramsci Shipping Corporation and Others v. Oleg Stepanovs ([2011] EWHC 333 (Comm)) can be accessed at http://www.bailii.org/ew/cases/EWHC/Comm/2011/333.html.

The text of the Chancery Division's judgment in Trustor AB v. Smallbone & Others ([2001] 1 WLR 1177) can be accessed at http://www.bailii.org/ew/cases/EWHC/Ch/2001/703.html.

The text of the Family Division's judgment in Ben Hashem v. Ali Shayif ([2008] EWHC 2380)) can be accessed at http://www.bailii.org/ew/cases/EWHC/Fam/2008/2380.html.

The text of the Chancery Division's judgment in VTB Capital PLC v. Nutritek International Corp and Others ([2011] EWHC 3107) can be accessed at http://www.bailii.org/ew/cases/EWHC/Ch/2011/3107.html.

Mark Dawkins is a Partner in the London office of Bingham McCutchen LLP. A litigator in the City of London for more than 25 years, Mark Dawkins is a recognized leader in financial litigation, fraud, and asset recovery. He may be contacted at mark.dawkins@bingham.com.