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Piercing the Corporate Veil and Enforcement

Yarik Kryvoi (British Institute of International and Comparative Law (BIICL)) · Monday, May 3rd, 2010

King Solomon might have split the baby had he not realised the identity of its parent in time. Judges and arbitrators – some 3,000 years later – might be quicker to identify a company's real group structure, but are they any better in splitting parent from child-subsidiary?

A typical corporate veil piercing case involves a controlling shareholder that sets up an undercapitalized corporation to incur obligations to third parties; the shareholder then siphons off the proceeds of its corporate borrowing received from those third parties. When the company's debts become due the company has insufficient assets to meet its repayment obligations. At that point, the controlling shareholder relies on the principle of limited liability to avoid personal liability. The result is that the third parties end up bearing the exposure.

In such situations, a court or tribunal may intervene to prevent the obvious injustice by piercing the corporate veil so as to hold the controlling shareholder accountable.

Despite various theories justifying corporate veil piercing, the presumption is – however – **not** to do so. Piercing the veil remains an exception not the rule. Approaches differ not only from one jurisdiction to another, but also within the same national systems of law.

For example, the general rule in the Civil Code of Russia is that each company has separate and distinct legal identity. On the other hand, the 2008 law on foreign investments in strategic sectors of the economy relies on the concept of group of entities. The law applies to investors and groups of companies that want to buy stakes in Russian companies working in one of strategic sectors, such as television broadcasting, defence and the telecommunications industry. In accordance with this law, a 'group of entities' is seen as one economic and legal actor which includes offshore subsidiaries. In effect, this amounts to piercing the corporate veil, i.e. disregarding separate legal identity of corporations.

The 'proper' approach to piercing the corporate veil and outcome is even less predictable in the context of international commercial arbitration.

Unlike national courts, arbitral tribunals do not have enforcement mechanisms of their own and need to resort to national courts. If a tribunal renders an award against a party which is not subject to the underlying arbitration agreement, problems will likely arise at the enforcement.

Article V of the New York Convention provides five procedural defects, on which national courts can rely to refuse recognition and enforcement of arbitration awards. These are (1) lack of valid arbitration agreement; (2) denial of opportunity to be heard; (3) an excess of jurisdiction by an arbitrator in deciding matters beyond the scope of the arbitration submission; (4) procedure contrary to the parties' agreement; and (5) annulment of the award in the country where rendered.

Arguably, an award rendered against a non-signatory can be challenged on the basis of any of these grounds, especially if there was no explicit arbitration agreement. For instance, a company that has not signed the arbitration agreement may not be present at the hearings, and is, thus, denied an opportunity to be heard. Local courts might annul the arbitration award against the parent company if the arbitration agreement was not in writing.

However, UNCITRAL noted in its report on written form for arbitration agreement that national courts increasingly adopt a liberal interpretation of the requirement of a written contract.* They construe it in accordance with international practice and the expectations of the parties.

Despite these new developments observed by UNCITRAL, the unpredictability with respect to arbitrations that involve piercing the corporate veil remains a serious problem. Not only is it unclear whether a particular tribunal would be sympathetic towards piercing the corporate veil under applicable domestic law, but the parties must face even greater challenges at the stage of enforcement.

Piercing the corporate veil may help to give a concrete practical meaning to the object and purpose of an arbitration agreement. However, there are downsides of such piercing which negate many of the benefits which the corporate form offers. Creditors will be in a more difficult position to monitor assets of the corporations they are dealing with. And corporations will be unwilling to take business risks which may result in their shareholders' corporate or personal assets being exposed.

Therefore, as a practical matter, it is better to make arbitration agreements as inclusive as possible. This will help to avoid dealing with piercing the corporate veil altogether.

The full text of the draft paper "Piercing the Corporate Veil in International Arbitration" to be published in Global Business Law Review is available here.

* U.N. Commission on International Trade Law [UNCITRAL], Working Group on Arbitration, Working Group on Arbitration, Working Paper: Possible Rules on Certain Issues Concerning Settlement of Commercial Disputes: Conciliation, Interim Measures of Protection, Written Form for Arbitration Agreement, ¶¶ 11 and 12(m), A/CN.9/WG.II/WP.108/Add. 1 (Jan. 26 2000).

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