DISREGARD OF THE LEGAL ENTITY IN SCANDINAVIAN COMPANY LAW

BY

ERIK HØRLYCK

© Stockholm Institute for Scandianvian Law 1957-2009

1. ON COMPANY LAW IN GENERAL

All the Scandinavian countries have legislation concerning limited companies. The Danish Companies Act was adopted in 1973, the Norwegian and Swedish Acts in 1975. These statutes are based essentially on common Scandinavian preparations and are composed of partly identical rules. The Danish Act, however, has recently to some extent moved away from the other two Scandinavian statutes, having been modified to meet the requirements of EEC harmonization.[1]

All these statutes have rules whereby decisions on behalf of a company either are adopted by a shareholders' meeting or are made by a board elected directly or indirectly by the shareholders' meeting. According to European continental traditions the direction of a company's affairs is in the hands of two organs, namely the *board of directors* and the *management*.

In contradistinction to Norway and Sweden, Denmark has special legislation on certain private companies ("anpartsselskaber") which are to some extent modelled on the German *Gesellschaft mit beschränkter Haftung*, the French *Société à responsabilité limitée* (S.A.R.L.) and other similar organizations. These companies are not taken into consideration in this paper. In fact they display no major differences as compared with other companies as far as the question of disregard of the legal entity is concerned.

A Scandinavian limited company can have only one shareholder. In small companies the *board* can have only one member and any company can have a one-man *management*.

Apart from these situations, the Scandinavian Companies Acts imply that company matters are decided by majority votes.

However, this does not mean that decisions made are always for the benefit of the company.

The company may be controlled by one or more shareholders, who command all or a majority of the votes at shareholders' meetings. Companies with shares distributed over a large number of shareholders may even be controlled by some shareholders who do not have a majority.

[1] The Danish company-law reform is described by Bernhard Gomard in Frommel & Thompson, *Company Law in Europe*, London 1975, pp. 125–67. The chapter about Swedish company law in this book relates to an earlier act of 1944.

© Stockholm Institute for Scandianvian Law 1957-2009

It is obvious that, in companies controlled by one or more shareholders, it is not to be taken for granted that the control will always be performed for the benefit of the company (though often this is the case, of course); it may instead be exercised for the exclusive benefit of the controlling shareholders.

If the controlling shareholder is another limited company, the two companies constitute a "company group". The concept of company groups in Scandinavian law does not necessarily imply common management, even though in practice the control as a rule results in a common management, a group management.

> The Scandinavian Companies Acts speak of a group in two cases. First, where a company or a company and its subsidiary or subsidiaries command a majority of the votes at shareholders' meetings. Secondly, where a company by virtue of possession of shares or an agreement has a determining influence on another company and is entitled to a substantial share of its net profits.[2]

However, a company may be controlled in other ways than by virtue of voting rights at shareholders' meetings.

As appears from the concept of company groups described above, control by agreement can form the basis of a group. There can be an agreement between companies (or between a company and individuals) concerning management, matters of supply, matters of marketing or financing, etc., which results in a situation where a company (or companies) or individuals are controlling parties in relation to (another) company, in such a way that—even though formally the controlled company has its own shareholders' meeting, board of directors and management—it nevertheless has to act according to the will of the controlling party or parties.

Control by agreement can occur without the existence of a company group. First of all, mention should be made of the shareholders' agreement on common voting at shareholders' meetings, according to which a number of shareholders can exercise control over these mettings.[3]

Control by business partners does not depend exclusively on agreements. In practice business enterprises are often dependent on main suppliers, main buyers, financers, etc., whose dispositions are decisive in the sense that in reality they are controlling in relation to the enterprise (even though such power of control is far from being exercised in all situations where it can be used).

[2] The Danish Companies Act sec. 2, the Norwegian Companies Act secs. 1–2 and the Swedish Companies Act sec. 1:2. Cf. Gomard, *op. cit.*, pp. 131 f.

[3] See Carl Martin Roos, "Comparative notes on shareholders' voting agreements", 15 *Sc. St. L.*, pp. 163–89 (1971), and Bernhard Gomard, "Shareholders' agreements in Danish law", 16 *Sc. St. L.*, pp. 97–142 (1972).

© Stockholm Institute for Scandianvian Law 1957-2009

But for the law it is a major task to protect a company (and its minority shareholders, its creditors, employees, etc.) against misuse of control.

The problem here stated—that the organs of a company may not always use their power for the benefit of the company—is only one aspect of the question. The other aspect is that it is not only the interests of the company that are of importance. First of all, the creditors of the company must be mentioned. Obviously, their interests are not always identical with those of the company, and therefore decisions for the benefit of the company are not always for the benefit of its creditors.

Not until a company is bankrupt do the creditors have a formalized influence on the direction of the company, and therefore there is a need for protection against fraud and dishonest conduct of the company's affairs.

Indeed, this is mainly a task for the law of bankruptcy, since fraud is a problem not only when the debtor is a company but also when he is an individual. However, the problem is of especial interest in company law because as a main rule the individuals who decide the affairs of a company, in contrast to an individual who decides his own affairs, have no personal liability in relation to the creditor of the company.

This is not the whole answer to the question. There is a demand for protection not only of the interests of the company (including the minority shareholders) and its creditors, but also of other interests. Above all the interests of the company's employees must be considered, since these interests depend on how the control of the company is exercised. In addition, public interests must be taken into account, e.g. the observance of trade, antitrust and tax law and laws on unfair competition.

Recently it has come to be recognized in company law that it is not only the interests of a company (and its creditors) that are of importance. In this connection mention can be made of legislation on participation of public authorities and employees in the management of companies.[4]

The purpose of the above reflections is not to suggest that control of a company is objectionable or obnoxious. On the contrary, control is often essential for business success. The establishment of a group through acquisition of a controlling block of shares may be a precondition for the requisite supply of capital and technical know-how and the necessary establishment of marketing opportunities. Correspondingly, the entering into a joint-venture agreement may both imply control of a company and safeguard its future prospects.

[4] Cf. Jytte Thorbek, "Employee participation, public shareholding for employees and state-appointed representation in Danish enterprises", *JBL* 1973, pp. 382–6.

© Stockholm Institute for Scandianvian Law 1957-2009

However, control also implies a risk of fraud and infringements arising through the neglect of major interests.

To some extent the Scandinavian Companies Acts have paid regard to this consideration.

This is mainly the case concerning the protection of a minority. Any resolution adopted at a shareholders' meeting which interferes with the shareholders' rights to dividends and distribution according to the company's articles of association, interferes with rights to transfer shares, imposes obligations to redeem shares or secures to certain shareholders or others an undue advantage at the expense of other shareholders or of the company is void unless the resolution was passed unanimously, or at any rate with the consent of those shareholders who may consider their rights to be infringed.[5]

Furthermore, the rules in the Scandinavian Companies Acts on damages should be mentioned in this context. The members of the board and the management can be held responsible for damage to the company and third parties caused by wilfulness or negligence, and even shareholders can in some cases be held responsible for offences committed wilfully or with gross negligence.[6]

However, the Scandinavian legislation on companies does not have any general attitude about the consequences of an abuse of the concept of a limited company through exercise of control of a company.

This is the background for the question of disregard of the legal entity, which in Scandinavian company law (as also in company law in the West European countries and in the United States) is dealt with mainly in case law. The question asked in this context is whether the existence of a company may be disregarded in some cases when control of the company has been exercised in a fraudulent way.

2. THE CONCEPT OF DISREGARD OF THE LEGAL ENTITY

A general definition of this concept is not to be found in Scandinavian company law.[7]

[5] Cf. Curt Olsson, "General clauses for the protection of minority shareholders in the Scandinavian companies' acts", 11 *Sc. St. L.*, pp. 269–95 (1967), and Gomard, *op. cit.*, p. 144.

[6] See Gomard, *op. cit.*, p. 149.

[7] The concept has been developed mainly in American, Swiss and German company law. The major works are Silvio Caflisch, *Die Bedeutung und die Grenzen der rechtlichen Selbständigkeit der abhängigen Gesellschaft im Recht der Aktiengesellschaft*, Winterthur 1961; Ulrich Drobnig, *Haftungsdurchgriff bei Kapitalgesellschaften*, Frankfurt a/M–Berlin 1959; Philip Frankenberg, *Die konzernmässige Abhängigkeit*, Zürich 1937; Heinrich Kronstein, *Die abhängige juristische*

© Stockholm Institute for Scandianvian Law 1957-2009

That no need has been felt for statutory rules on disregard may be due to two circumstances.

First, the rules on damages mentioned above, which make it possible to hold directors and managers personally responsible for their fraudulent use of the fiction that they are acting on behalf of a company.

Secondly, the rules in bankruptcy law on invalidation of a debtor's transactions. These rules are dealt with briefly in section 3 below.

There is no doubt of the importance of the rules in question for the protection against fraud by the abuse of limited companies, but they are not sufficient.

To begin with, it may be reasonable to point out the meaning of the concept of disregard.

It is a fundamental principle in company law that incorporated companies are independent bearers of their own rights and obligations, that a company is a legal person with assets separate and distinct from the persons who are its shareholders and directors. This principle leads to the recognition of limited liability: the company with its own assets is the sole debtor in respect of its obligations.

It is of great importance for business life that this principle should be preserved, since it is a necessary precondition for investments by the general public in business enterprises.

But the reverse of this principle is the contingency of fraud based upon the lack of liability in respect of the persons acting for the company or controlling it. Therefore, in certain situations there may be a need to provide that the principle in question shall give way to the requirement of protecting the defrauded, i.e. to prescribe that in a given case a company cannot be regarded as a separate legal person.

It must be stressed that the concept of disregard of the legal entity does not refer to certain particular and plain legal consequences.

The point is that the court, basing itself upon a concrete evaluation of the circumstances, may react as it considers appropriate. It may be a matter of completely rejecting the legal existence in every respect of the controlled company, or a matter of disregarding a certain transaction of the controlled company.

This point of view can be illustrated by the turnover rule, applied in some American cases, that a subsidiary may be dependent to such a degree that in case of bankruptcy of the holding company the assets of the

Person, Berlin 1931 (reprinted 1973); Elvin R. Latty, *Subsidiaries and Affiliated Corporations*, Chicago 1936; Herbert Schönle, *Die Einmann- und Strohmanngesellschaft*, Munich 1957; Rolf Serick, *Rechtsform und Realität juristischer Personen*, Berlin–Tübingen 1955; and Isaac Maurice Wormser, *Disregard of the Corporate Fiction and Allied Corporate Problems*, New York 1929.

© Stockholm Institute for Scandianvian Law 1957-2009

subsidiary shall be included in the estate of the holding company's bankruptcy, even though the creditors of the subsidiary may have a preference.[8] However, in other similar cases the reaction may be restricted to a duty to restitute favours.

A very important and typical reaction is to disregard the rule of limited liability, with the effect that the liability will be imposed on the (controlling) persons or companies.

A decision like this may be based upon the application of the rules on damages concerning misrepresentation on the part of directors and controlling shareholders. But these rules are not sufficient. First, there are in the law of torts certain requisites which particularly impede the imposition of liability on controlling shareholders (including holding companies). Secondly, the rules can only be applied to those who are bound by special duties to the company—such as directors and to some extent controlling shareholders—and not to those who exercise control in a more informal way.

The earlier-mentioned rules on invalidation of transactions as an effect of bankruptcy may lead to disregard of certain transactions to the disadvantage of controlling persons and companies. For that reason a few remarks should be made on this matter.

3. INVALIDATION AS AN EFFECT OF BANKRUPTCY

All the Scandinavian countries have bankruptcy acts with rather detailed rules on invalidation of certain of the debtor's transactions. In that respect these rules constitute an effective protection against misuse of control of a company, and it may well be asked whether there is any need at all for special rules on disregard of the legal entity.

This question must be answered in the affirmative. In the first place the rules on invalidation presuppose that the controlled company is bankrupt, but there may be a need to pierce the corporate veil in cases where the company is not bankrupt. Secondly, the rules on invalidation can only be pleaded by the receiver of the estate in bankruptcy, but there may be a need for a rule that individual creditors, contracting partners, etc., shall be entitled to take action. Thirdly, the rules on invalidation presuppose transaction which give other persons an advantage at the expense of the controlled company, but there may be a need to cover other kinds of abuse of control of a company as well.

The rules on invalidation as an effect of bankruptcy can in the case of

[8] Cf. Latty, *op. cit.*, pp. 42 f. and pp. 49–52.

© Stockholm Institute for Scandianvian Law 1957-2009

controlled companies be classified as special rules on disregard of the legal entity, but these rules alone are not sufficient.

For a long time it has been recognized in the Scandinavian law of bankruptcy that there is a need for particular rules on invalidation of transactions concerning the bankruptcy of a controlled company.[9]

In recent years the legislation on bankruptcy in Denmark and Sweden has extended the possibility of invalidation of a controlled company's transactions on the basis of special rules on invalidation of transactions to the advantage of "closely related persons". Proposals for similar rules are expected to be adopted in Norway.

According to the Danish Bankruptcy Act, sec. 2, the concept of "a closely related person" is defined—with regard to companies—as follows: (1) a person or anyone closely related thereto who is directly or indirectly the owner of a substantial part of the company's share capital; (2) a company or persons mutually closely related who are directly or indirectly the owner of a substantial part of the company's share capital; (3) a person or a company or mutually closely related persons or companies who are directly or indirectly the owner of a substantial part of both the favoured and the bankrupt companies' share capital; (4) other cases of similar relations.

The definition in the Swedish Bankruptcy Act, sec. 29 a, is on the whole similar, but includes the relation between a company and a person who has a controlling influence as a leader of the company.[10]

4. CASES OF DISREGARD OF THE LEGAL ENTITY

As mentioned earlier in this paper, the question of disregard is not regulated in Scandinavian legislation (except for the rules in the bankruptcy acts), but there are certain court decisions on the matter. It should, however, be pointed out that Scandinavian courts have not been so much inclined as American and German courts to state disregard; this is a result of the stricter rules on distribution of profit to the shareholders in Scandinavian law.[11]

As pointed out by P. Nilsson-Stjernquist,[12] the question of disregard is not a question of either/or, since the court may react in different ways

[9] See, e.g., Lars Welamson, *Konkursrätt*, Stockholm 1961, pp. 253–5, and Sjur Brækhus, *Konkursrett*, Oslo 1970, pp. 138 f.

[10] The Scandinavian rules in bankruptcy law on "closely related persons" are commented on by Niels Ørgaard, *Konkursret*, 2nd ed. Copenhagen 1977, pp. 129 f., Mogens Munch, *Konkursloven af 1977*, Copenhagen 1978, pp. 58–61, and Lars Welamson, *Konkurs*, 5th ed. Stockholm 1976, pp. 67 ff.

[11] Cf. Håkan Nial, *Svensk associationsrätt i huvuddrag*, 2nd ed. Stockholm 1976, pp. 200 f.

[12] See P. Nilsson-Stjernquist, *Föreningsformens funktion*, Lund 1950, pp. 83 f.

© Stockholm Institute for Scandinavian Law 1957-2009

according to the kind of abuse of the control of a company which is in question.

The most extreme possibility is a complete denial of the existence of the controlled company as a legal person. On the other hand, the court can restrict its reaction to a disregard in a specified way and in a certain relation identify the controlling persons or companies with the company.[13]

It is scarcely determinative in what way the control has been exercised —whether on the basis of possession of shares or on a basis of agreement or in some other way—or whether the controlled company has many or few shareholders.[14]

On the other hand, the most frequent cases of disregard concern companies which are controlled by one or a few shareholders.[15]

It is my intention in what follows to refer to some of the most important cases where Scandinavian courts have stated that the corporate fiction should be disregarded.

It is perhaps controlled companies with insufficient capital that present the most usual case. The situation is that even though the company was founded with the required minimum capital stipulated in the legislation, it was used to carry into effect business activities the riskiness of which was disproportionate to the capital available. If the establishment of the controlled company had no other purpose than that of avoiding personal liability, there may be a ground for imposing a liability for the controlled company's debts on the controlling persons or companies.

In cases of that kind it could be said that the controlled company is nothing but a "dummy" of the controlling persons or companies, or—as stated in *Chicago, Milwaukee & St Paul Railway Co.* v. *Minneapolis Civic & Commerce Ass.*[16]—there is a basis of identification if the arrangement had "the purpose of controlling a subsidiary company so that it may be used as a mere agency or instrumentality of the owning company or companies".

That point of view can be illustrated by a number of Scandinavian decisions. The NJA cases are decisions of the Swedish Supreme Court, the UfR cases are Danish and the NRt cases Norwegian decisions.

1935 NJA 81. A tailor had founded a limited cooperative society. The members were the tailor himself and four of his employees. After the society had

[13] The main problem connected with a complete rejection of the legal existence of a controlled company is the consequent rejection of the priority of its creditors to the assets of the company, cf. Nilsson-Stjernquist, *op. cit.*, pp. 101–03.

[14] Cf. Nial, *op. cit.*, p. 204.

[15] Cf. Serick, *op. cit.*, p. 95, and Harry G. Henn, *Handbook of the Law of Corporations*, 2nd ed. St. Paul, p. 252 and pp. 256 f.

[16] 247 U.S. 490, 62 L.Ed. 1229 (1918).

© Stockholm Institute for Scandianvian Law 1957-2009

gone bankrupt, it was decided that the tailor personally was liable for its debts as the society had been run as his own personal enterprise.[17]

1942 NJA 473. This decision also concerned a limited cooperative society. The majority of the shares in the society were owned by a company which erected a factory for its own use on the society's land. Some adjoining premises were damaged. The company was held responsible, since it had used the society's land as its own.

1947 NJA 647. Some power-station companies had founded a limited company for the purpose of building an embankment between two lakes. The companies were held responsible for damage caused by the embankment.[18]

1966 UfR 732 (Copenhagen Court of Commerce). A director of a limited company, who was also a major shareholder in it, was held personally liable for the company's debts because he had run the company as his own personal enterprise.

1968 UfR 41. The situation was similar to that in 1966 UfR 732.

1974 UfR 129. This case, too, concerned a situation similar to that in 1966 UfR 732.

1975 NJA 45. Two companies A and B were owned by the same shareholders. Company A had acted as an agent of company B. Company B was held responsible for the debts of the agent company since its capital had been insufficient.

1975 NRt 198. The directors and shareholders of a limited company were held liable for the purchase price for some goods bought by the company a short time before its bankruptcy.

1976 UfR 909. The situation was similar to that in 1975 NRt 198. The Court held that the shareholder should have made it clear to the seller that the company would be the sole debtor.

1977 NRt 608. The case concerned a joint venture between two companies A and B. The Norwegian Supreme Court held that a director of company B was responsible for the loss of a supplier to A as he had neglected his duty to see to it that company A received payments for its sales.

It must be pointed out that identification of the controlling persons or companies with the controlled company is not in every case the consequence of insufficient capital. This would be contrary to the fundamental idea of permitting the existence of companies with limited liability. The decisive matter is whether the controlled company has been used exclusive-

[17] This decision is excessive, considering there is no reference to inadequate capital.
[18] See, on the first three decisions mentioned, Nilsson-Stjernquist, *op. cit.*, pp. 96–100, and Jan Hellner, "Juridiska personers skadeståndsansvar" in *Teori och Praxis, Festskrift till Hjalmar Karlgren,* Stockholm 1964, pp. 146 f. and pp. 165 f.

© Stockholm Institute for Scandianvian Law 1957-2009

ly as an agent of the controlling parties and for their benefit without paying regard to the interests of the creditors.[19]

The major cases of identification as a result of insufficient capital are cases where a controlled company has engaged in risky activities, but without sufficient working capital, equipment and plants, with the consequence that creditors have been defrauded.

Related to the above type of disregard are cases of extortion; i.e. where the controlling persons or companies have charged excessively high prices for goods sold by them to the controlled company. If the result of such extortion is that the controlled company cannot fulfil its obligations to its creditors, an identification may be established, though with a limit corresponding to the enrichment.

> *1917 UfR 296 (Copenhagen Court of Commerce).* The shareholders of a company had discontinued the company's activities and shared its assets among themselves. They were held responsible for its debts.
>
> *1968 UfR 766.* An aviation company had founded a subsidiary company and agreed with some of its customers that their payments for flights should go to the subsidiary. It was stated that these payments ought to be added to the aviation company's estate of bankruptcy.

A similar point of view has been expressed concerning the case where a controlling business partner had replaced himself as debtor in relation to the controlled company by an assignee who was not able to pay.[20]

Another important case of disregard is the evasion of obligations to act or omit to act by the abuse of a controlled company. The practical case concerns covenants in restraint of trade. The problem is whether there is a breach of duty when a person bound by a covenant in restraint of trade carries out a forbidden activity through a company under his control. A similar problem arises when the controlled company is bound by a covenant in restraint of trade and its controlling shareholder carries out the activity. There are Scandinavian decisions in which the Court has answered the former question in the affirmative and then rejected the legal independence of the company in relation to the controlling persons or companies. On the latter question there are no decisions.[21]

> *1909 UfR 644 (Copenhagen Court of Commerce).* A person A bound by a covenant in restraint of trade was held liable to pay a penalty when a company founded

[19] Cf. Nilsson-Stjernquist, *op. cit.*, pp. 63 f., O. A. Borum in *Festskrift til Stephan Hurwitz*, Copenhagen 1971, p. 80, Bernhard Gomard, *UfR* 1971 B, p. 125, and Gomard, *Aktieselskaber og anpartsselskaber*, Copenhagen 1974, p. 26.

[20] Cf. Knut Rodhe, *Förtäckt vinstutdelning och lån från aktiebolag*, Stockholm 1973, pp. 19 f.

[21] Håkan Nial, *Aktiebolagsrättsliga studier*, Stockholm 1935, p. 120, expresses the opinion that a covenant in restraint of trade that is binding on a company is binding on its sole shareholder as well.

© Stockholm Institute for Scandianvian Law 1957-2009

by his brother, but based upon a loan from A, had undertaken the forbidden activity.

1922 NJA 144. The shareholders in a limited company transferred their shares to a buyer and undertook an obligation to exercise no competitive activities against the company. One of the former shareholders founded a new company in conjunction with third parties and became its director and general manager. This company carried out competitive activities in relation to the former company. An injunction was made against his participation in the management of the new company.

A similar question arose in a case concerning an option on certain real estate. The problem was whether the option could be exercised when the real estate was bought by a newly founded company with the purpose of evading the option by selling the shares instead of selling the estate.

1966 UfR 145. A municipality had sold some real estate to a newly founded company with an option to claim it back if resold. The municipality had the right to take the estate back even though the estate was not resold, but within four months all the shares of the company had been transferred to another shareholder.

© Stockholm Institute for Scandianvian Law 1957-2009