CHAPTER I
INTRODUCTION

A. Research Background

At the beginning of the nineteenth century, corporations were nonexistent and business enterprises were relatively small. However, many industries around the world, especially in superpower countries, were then dominated by large corporations at the end of the century. There are two factors in particular that were believed to have contributed to this development, which are state laws and the advancement of technology. The laws passed by states concerning corporations in general created a legal atmosphere that favoured incorporation whereas technological developments made large-scale enterprises possible and profitable[1].

When the century dawned, merchant capitalists were the dominant figures in the commerce sector. Merchant capitalists usually are individuals who owned more than one business and made every decision in their businesses[2]. Furthermore, they usually worked with one or several partners, were assisted by their family members, or have a small number of employees. For instance, manufacturing businesses were often operated by a craftsperson, who were assisted by no more than two apprentices. Textile and shoes industries adapted the putting-out system or also commonly known as the domestic system, which is a production system whereby merchant-employers delivered materials to home-based producers in rural areas from and drew the finished goods to a central warehouse[3]. Large-scale concerns, such as shipyards and iron factories, rarely employed more than fifty workers.

This situation, however, changed drastically between the year 1815 and 1849 for two major reasons. During the 1820s, the Industrial Revolution has begun to spread across England to New England whereby factory system is

[1] Leonardo Davoudi, Christopher McKenna and Rowena Olegario, "The Historical Role of the Corporation in Society", *Journal of the British Academy* 6, no. 1 (2018): p. 18.
[2] Ibid.
[3] Ibid.

rising because of the economies of scale[4] and increased use of machinery[5]. By 1840, this system had almost completely superseded the operations by craftsperson and the domestic system. This is because when factory system was surging in 1820s, corporations had begun to replace individuals and limited partnerships as primary mechanism of business ownership. Consequently, to accommodate with such development, there were also several legal changes that made incorporation more appealing[6]. For example, states had changed their incorporation laws in a way that a simple payment of a fee was sufficient to create a corporation. This was followed by the establishment of the precept of limited liability through state court decisions in Vose v Grant (1818) and Spear v Grant (1919), which made sure that stockholders are protected from financial ruin should their business enterprises failed or went bankrupt[7]. In addition, the court's ruling in Trustees of Dartmouth College v Woodward in 1819 also guaranteed that a corporation's charter is inviolable[8]. Between 1840 and 1860, corporation had become the preferred mechanism to finance and organise a business.

The doctrine of corporation is a succession of people, who lawfully creates an existence with rights and duties that is a completely separate and distinct from those people who are also often referred to as its members[9]. Hence, a corporation has its own legal personality, which is quite separate and distinct from its members, such as the shareholders, the managers, or the employees. As a corporate is an artificial, non-real person legal fiction, it needs others to act on behalf of it. There are two organs of a corporate who can act on behalf of the company, which are shareholders and board of directors. Shareholders in a company have a limited role as some referred to them as the shadow of the company. Theoretically, they set up the company by investing in it, thus they are able and entitled to pass resolutions

[4] Economies of scale refer to the cost advantage experienced by a business when it increases its level of output. The advantage arises due to the inverse relationship between per-unit fixed cost and the quantity produced. The greater the quantity of output produced, the lower the per-unit fixed cost.
[5] Ibid.
[6] Ibid, p. 19.
[7] Ibid.
[8] Ibid.
[9] Seyedeh Roudabeh Hosseini et al, "Holding Companies' Strategies and their Distinction from Large Organizations, Investment, Trust and Merger", *European Online Journal of Natural and Social Sciences* 2, no. 3 (2013): p. 2928.

for certain acts to be carried out by the directors[10]. This also means that shareholders are the ones who set the constitution of the company, which outlines the rights and duties of the directors. The board of directors, on the other hand, is a term to collectively describe the group of people sitting as directors of the company. The members of the board of directors are usually appointed by the shareholders. Furthermore, the board of directors have entirely different duties from the shareholders, whereby they have the responsibility to manage the everyday affairs of the company and to delegate powers or rights to managers. In short, the board of directors has the duty to implement the company's strategic and operational objectives. Therefore, the board of directors could be considered as the main organ of the company.

Based on the explanation above, it could be said that a corporation constitutes of a group of people who associates themselves for a common objective, mainly for economic gain. Hence, one of the unique main features of a corporation is its separation of risks[11]. A corporation form allows the owners of the corporation to be free from any risks involved in the operation of the corporation. This means that the personal assets of both the shareholders and the directors are protected from being taken to pay the debts of the corporation. In short, for the shareholders, their responsibilities are limited to the amount of company shares they owned, while for the directors, their responsibilities are limited to any personal guarantees they gave as securities for the corporation's debts and to any wrongdoings they have incurred under the law when managing the corporation. Thus, this concept is known as limited liability.

However, the idea of limited liability is viewed differently in a corporate group structure. Corporate group referred to a group of companies that consists of a parent company and subsidiaries with the purpose to maximise their profits while at the same time minimise their risks[12]. Thus, it is considered a common strategy for corporations to function as corporate groups in order to have systemised dealings, to enter the global market competition, and to grow more market shares. Corporate groups were first established before the World War II in some European

[10] Ibid.
[11] Ibid, p. 2929.
[12] Ibid.

countries[13]. It then reached Asia and Africa during the 1960s and 1970s. Between 1988 and 1991, a more advanced form of large-scale corporate groups emerged in Algeria and Egypt, which had an extensive effect on such organisational structures and their operational activities[14].

The concept of corporate group itself emerged from the need to separate a large-scale corporate into separate legal entities according to their industries and the need for those corporates who have their own legal personality to still be under one ownership with a centralised control[15]. In Indonesia, the concept of corporate group is not directly and specifically regulated by the constitution. Nonetheless, the idea of corporate group is not something new as it could be considered as a necessity in the ever-developing Indonesia's business community. With the concept of corporate group, many believe that a corporate could create a more efficient business. The existence of corporate group itself often generates polemics because it is frequently criticised as a management strategy that is in line with monopoly or unhealthy business practice. Not only that, the limit of liability of both the parent company and the subsidiary is also in a grey area because of the legal vacuum regarding corporate group practice. Therefore, when discussing the concept of corporate group, many often use Law of the Republic of Indonesia Number 40 of the Year 2007 concerning Limited Liability Companies (hereinafter referred to as "2007 Limited Liability Companies Law") and Law of the Republic of Indonesia Number 5 of the Year 1999 concerning the Ban on Monopolistic Practices and Unfair Business Competition (hereinafter referred to as "1999 Monopolistic Practices Law") as a reference or as a guideline.

On the other hand, the concept of corporate group is more common in the United States of America (hereinafter referred to as "US") and in the United Kingdom (hereinafter referred to as "UK"). In the US, the relationship between a parent company and its subsidiary or affiliate is regulated under the US Companies Act. Parent company, as defined by the Act, is a company that is created specifically to be a shareholder of another company with the purpose to invest with or without

[13] Martin Petrin dan Barnali Choudhury, "Group Company Liability", *European Business Organisational Law Review*, no. 19 (September 2018): p. 772.
[14] Ibid.
[15] Ibid.

actual control. The basic rule in the relationship between a parent company and its subsidiaries is that there is a limited liability whereby the parent company would not be held liable for the acts of its subsidiaries[16]. This is in accordance with the separate legal personality, which is one of the key features of a corporate form. In United States v Best Foods, it was emphasised that the general principle of the corporate law in US does not held a parent company liable for the acts of its subsidiaries[17].

Similarly, the English Company Law through Companies Act 2006 also defines holding company as a company, which has voting control, director control, or contract control on its subsidiaries[18]. The liability of a parent company towards the acts of its subsidiaries is also regulated in accordance with the concepts of limited liability and separate entity[19]. From the period when companies made legal incorporation, they are considered as an autonomous legal personality[20]. Hence, the company is a separate legal entity distinct from its members, such as the shareholders. Based on the definition of parent company in Companies Act 2006, a parent company is considered as one of the shareholders of its subsidiary, thus it has the same limited responsibilities and liabilities of a shareholder in general. This limited liability of shareholders is further analysed by the House of Lords[21] in Solomon v Solomon & Co. Ltd case and then the English courts followed the judgment in subsequent cases such as Adams v Cape Industries Plc, whereby in summary, the English company law recognises the creation of subsidiary company and although in a sense it is a part of its parent company, nevertheless the general law looks upon it as a separate legal entity[22].

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[16] Ibid, p. 778.
[17] Ibid.
[18] Leonardo Davoudi, Christopher McKenna and Rowena Olegario, op. cit, p. 25.
[19] Ibid.
[20] Ibid.
[21] The United Kingdom Parliament has three parts, consisting of the Sovereign or the Queen-in-Parliament, the House of Lords, and the House of Commons, which is the primary chamber. The House of Lords includes two different types of members: the Lord Spiritual, consisting of the most senior bishops of the Church of England, and the Lords Temporal, consisting mainly of life peers, appointed by Sovereign on the advice of the Prime Minister, and of 92 hereditary peers, sitting either by virtue of holding a royal office, or by being elected by their fellow hereditary peers. Prior to the opening of the Supreme Court in 2009, the House of Lords also performed judicial role through the Law Lords.
[22] Ibid, p. 26.

Looking at the concept of limited liability explained above, it could be concluded that all three countries consider subsidiary companies as separate legal entities from their parent companies and hence, their parent companies have limited liability towards them. Although it is not specifically regulated in Indonesia, the creation of subsidiary companies has been practiced by large enterprises and so to follow the existing law in Indonesia, subsidiary companies are built in corporate forms, thus resulting in the subsidiary companies having their own legal personalities distinct from their parent companies. In addition, the concept of limited liability is also implemented, whereby the parent companies only act as shareholders of the subsidiary companies and so are not involved in any risks that could arise from the acts of the subsidiary companies.

In spite of the fact that limited liability is the key feature of a corporate, which is implemented by almost all company laws around the world, there are several instances whereby the concept of limited liability is ruled out. These instances are referred to as piercing or lifting the corporate veil. Today, the concept of piercing the corporate veil is commonly adopted in every modern law system with the only differences being the degree of acknowledgement and the different applications of such concept. In the studies of company law, piercing the corporate veil is considered a theory or a doctrine, which is defined as the process of shifting the responsibility over the legal actions of a corporate to another corporate notwithstanding the fact that the legal actions were carried out by a different entity[23]. In short, in the context of limited liability, the doctrine of piercing the corporate veil place the responsibility of subsidiary company's legal actions into the responsibility of the parent company, thus causing the parent company to be able to be held liable towards the acts of its subsidiary company.

In US, it is possible to held the parent company liable for the acts of its subsidiary company when the state law supports the doctrine of piercing the corporate veil. In order to held the parent company liable, the plaintiff must be able to prove that there is an apparent intention of the parent company to disregard the corporate entity in order to avoid duty owed to the plaintiff[24]. Such conditions could

[23] Martin Petrin dan Barnali Choudhury, op. cit, p. 781.
[24] Ibid, p. 782.

be seen in the case of Walkovszky v Cartlon, whereby the defendant ran ten different taxi corporations in unison and hence succeeded in shielding himself from liability. One of the judges of the case, in dissent, said that the defendant should be held liable for his subsidiary company's negligence[25]. This is based on the fact that the subsidiary company was intentionally undercapitalised in order to avoid liability, which shows an overt abuse of corporate entity.

During the twentieth century in UK, there was a need for exceptions to the general rule of limited liability. Therefore, between the end of 1960s and the beginning of 1970s, the Court of Appeal tried to establish a doctrine to control the piercing of corporate veil while the House of Lords tried to find a more orthodox approach[26]. In the case of Adams v Cape Industries plc in 1990, the Court of Appeal established that a true veil piercing may be carried out when it is proven that the corporation sued is established for fraud purposes[27]. In addition to fraudulent purposes, veil piercing may also take place when the company is set up to avoid any arising obligations[28]. Moreover, as a matter of tort law, the person in charge of the parent company may owe any accident victims of the subsidiary company a direct duty of care[29]. However, despite these conditions, piercing the corporate veil is quite rare in the English company law. Nonetheless, the law in UK still recognises the doctrine of piercing the corporate law as long as the facts of the case fulfill the conditions established in Adams v Cape Industries plc.

As mentioned in the explanation above, corporate groups or holding companies are not explicitly regulated in Indonesia let alone the doctrine of piercing the corporate veil. Nevertheless, as corporate law is developing rapidly, there are now a lot of large-scale business entities in Indonesia that do not operate in a single corporate form but in the form of corporate groups. In fact, these corporate groups, such as Semen Gresik Group, Astra Group, or Bakrie Group, only referred to the business reality of integrating several companies to create a corporate group as an economic unity. The absence of piercing the corporate veil doctrine in the

[25] Ibid.
[26] Ibid, p. 783.
[27] Ibid.
[28] Ibid.
[29] Ibid, p. 784.

Indonesian company law shows that the subsidiaries of such corporate groups are considered a separate legal personality, hence it is probably almost impossible to held the parent company liable for its subsidiaries' legal actions under any conditions. However, through the applications of the doctrine of piercing the corporate law by other countries such as US and UK, it could be deducted that it is important to implement the doctrine of piercing the corporate law under certain conditions and circumstances.

Based on all the explanation above, this paper will analyse the application of the doctrine of piercing the corporate law in US as well as UK and to discuss why it is necessary for the Indonesian company law to implement the doctrine of piercing the corporate veil. Therefore, this paper will discuss the implementation of piercing the corporate law doctrine in US and UK and possibly in Indonesia under the title: "COMPARATIVE STUDY OF THE IMPLEMENTATION OF PIERCING THE CORPORATE VEIL DOCTRINE IN INDONESIA, UNITED STATES, AND UNITED KINGDOM".

B. Research Questions

Based on the background described above, the problems that will be addressed in this paper are as follow:

1. How is the piercing the corporate veil doctrine implemented in Indonesia, US and UK?
2. What are the similarities and differences of the implementation of piercing the corporate veil doctrine in Indonesia, US and UK?
3. Should the piercing the corporate veil doctrine be regulated explicitly in Indonesia?

C. Research Purposes and Benefits

The objectives that this paper aims to achieve are:

1. To analyse the implementation of piercing the corporate veil doctrine in Indonesia, US and UK.
2. To identify the similarities and differences in the implementation of corporate veil piercing doctrine in Indonesia, US and UK.
3. To analyse whether the corporate veil piercing doctrine should be explicitly regulated in Indonesia.

On the other hand, the significance of this study is divided into two categories, theoretically and practically, which are as follows:

1. Theoretical significance

This paper aims to emphasis the necessity to create new regulation, which focuses more on corporate groups and their liabilities through piercing the corporate veil doctrine in order to lead the change in the business practices carried out by the business society in Indonesia in accordance to the legal development theory.

2. Practical significance

This paper aims to be the foundation for the reassessment of the regulation on corporate groups and the implementation of the piercing the corporate veil doctrine in the Indonesian company law and to put forward the discussion of whether piercing the corporate veil doctrine should be explicitly regulated on its own in the Indonesian company law by analysing the current implementation of the doctrine in Indonesia, US, and UK.