

Company & Commercial - Ecuador

In the Absence of Fraud, the Corporate Veil of a Subsidiary Remains Intact

Contributed by **Coronel & Pérez**

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In a recent ruling the Guayaquil Superior Court found that in the absence of clear and convincing evidence that a corporation had been established to carry out fraudulent activities, the corporate veil would not be pierced. The action was initiated by J&P C Ltda, an Ecuadorian corporation, against Nestlé SA, the Swiss food multinational. The court reversed the ruling of the lower court (which had awarded damages to the plaintiff for breach of contract) and dismissed the case on the grounds that the complaint should have been directed against Nestlé's subsidiary in Ecuador (Nestlé del Ecuador SA) since the subsidiary, and not its Swiss parent, was party to the distribution agreement. The court held that the elements that would allow the piercing of the subsidiary's veil were not present and a lawsuit against the parent company was thus unwarranted. The ruling was in line with Supreme Court opinions on the piercing of the corporate veil.

Facts

On May 1 1970 Mr Bolivar Jaramillo, as distributor, and Industria Ecuatoriana de Elaborados de Cacao SA (an Ecuadorian company then partially owned by Nestlé), as seller, executed an agreement for the distribution of certain food-processed products in Ecuador. When Nestlé took full control of Industria Ecuatoriana de Elaborados de Cacao SA, the company was renamed Nestlé del Ecuador. In 1989 Jaramillo assigned his rights to the contract to J&P. The plaintiff claimed that its task consisted mainly of distributing products of the Nestlé line and that its commercial activities under the contract became channelled through Nestlé. It added that around 1996 Nestlé SA began to do business directly with some of its clients; despite the plaintiff's protests, these dealings increased, which affected the plaintiff's market share significantly. Finally, according to the plaintiff, in 2002 Nestlé SA ceased to provide J&P with products, driving it out of business. J&P filed a lawsuit for damages for breach of contract under the provisions of Decree Law 1038-A,⁽¹⁾ claiming that its actual counterparty was Nestlé SA, rather than its Ecuadorian subsidiary. The decree law - which was repealed in 1997 - contained far-reaching mandatory provisions to protect local distributors in their dealings with foreign suppliers. According to the plaintiff, from the date of its promulgation, the provisions of the decree law replaced the clauses of the 1970 contract.

The judge of first instance ruled in favour of the plaintiff. The judge accepted the plaintiff's position that because Nestlé Ecuador was fully owned by Nestlé SA, (i) the distribution contract was actually between an Ecuadorian agent and a foreign supplier (hence the application of the decree law to the dispute), and (ii) the parent corporation was liable for the breach of the distribution contract that its subsidiary had executed in Ecuador. The judge upheld the claim of breach of contract and ordered the defendant to pay damages to the plaintiff.

Decision

The Guayaquil Superior Court reversed the first instance judgment on April 27 2006. The court focused mainly on the plaintiff's argument (successful in the first instance) that because Nestlé SA was the sole shareholder of Nestlé del Ecuador, Nestlé SA was the actual party to the distribution contract and thus had to answer for alleged breaches of the contract. The court relied on traditional principles of corporate law and reaffirmed the distinction between the corporation and its shareholders, which is critical where issues of liability are involved. In the opinion of the court, the doctrine of piercing the corporate veil (being an exception to a general rule) must be applied with extreme care. Its application is warranted only where there is clear and unambiguous evidence

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that the corporation has been established as part of a fraudulent scheme. However, the court found no evidence to support this conclusion in this case. It also found that the plaintiff's allegation that Nestlé SA became involved in the execution of the contract - a contention that the plaintiff failed to prove - was immaterial. The court held that corporations do not have to answer for actions carried out by their shareholders.

The plaintiff filed an appeal on cassation to have the ruling of the Guayaquil Superior Court annulled; however, on October 3 2006 the Supreme Court, without addressing the merits of the case, dismissed the appeal on procedural grounds.

Comment

The ruling is significant for foreign enterprises doing business in Ecuador through subsidiaries as it confirms the traditional view that the doctrine of piercing the corporate veil is an exceptional tool that must be applied only in unique circumstances. This is true even in cases where the Ecuadorian subsidiary was controlled by a sole foreign shareholder. The ruling is in line with Supreme Court case law. Although it accepted as valid the doctrine of piercing the corporate veil, the Supreme Court restricted its application to cases where it is beyond doubt that:

"the legal person has been established with the animus to deceive either the law or the interests of third parties or when - not by design, but as a result - the use of the veil of the juridical person produces the same fraudulent effects."⁽²⁾

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Endnotes

(1) Law for the Protection of Representatives, Agents and Distributors of Foreign Enterprises, which was issued in 1976 by a military junta.

(2) *Official Register* 273, September 9 1999, page 16.

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