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Analysis of the Piercing Corporate Veil

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Abstract: *Implicit in the company laws of common law jurisdictions is the notion of the corporate veil and the insulation of company shareholders from liability for debts of the company. The veil is not sacrosanct, however, and in appropriate circumstances courts will allow company creditors to pierce the veil and recover debts of the company directly from its shareholders. In contrast, the company legislation of China, supplemented by quasi-legislative rulings by the Supreme People's Court, provides company creditors with an explicit right to pierce the corporate veil and pursue shareholders for satisfaction of company debts.*

Keywords: *Piercing the Corporate Veil, Limited Liability, Corporations*

1. Introduction

Piercing the corporate veil–this is the assumption that some forms of corporations provide limited liability for their shareholders, therefore the legislator allows for a sort of immunity from debts. Theoretically,shareholders should not abuse of this rights. However, there might be some confusion depending on the meaning attributed to the abuse of limited liability. Despite the jurisprudence best endeavours, no universal agreement on this issue has been reached.Quite to the contrary, different systems offer different definitions of this concept. Consequently, different solutions have been provided in order to justify the disregard (the piercing) of limited liability (the veil).In conclusion, it is believed that a correct definition of limited liability abuse can help to clarify when the legal limitations of liability upon natural persons or corporations may be disregarded and veil piercing applied.

2. Legal Framework

Similar to other systems, in China, the disregard of the independence status of the corporations is carried out, mainly with the aim to safeguard company creditors' interests. Unlike some western systems, China offered direct statutory remedies for veil piercing. After 2005 veil piercing has been clearly recognized in the law[1].

Roughly speaking, the most common legal provision used by Chinese judges to disregard the veil of limited liability is article 20 and artical 63 of the Company Law of the People's Republic of China (hereafter Company Law), article 21 of Request for Public Comments on the Bill to Revise the Company Law (hereafter Bill to Revise the Company Law) and article 83 of Civil Code of the People's Republic of China(hereafter Civil Code).

2.1 Company Law

"The shareholders of a company shall abide by the laws, administrative regulations and bylaw and shall exercise the shareholder's rights under the law. None of them may injure any of the interests of the company or of other shareholders by abusing the shareholder's rights, or injure the interests of any creditor of the company by abusing the independent status of legal person or the shareholder's limited liabilities.

Where any of the shareholders of a company causes any loss to the company or to other shareholders by abusing the shareholder's rights, it shall be liable for compensation.

Where any of the shareholders of a company evades the payment of its debts by abusing the independent status of legal person or the shareholder's limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liabilities for the debts of the company".(Artical 20)

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"If the shareholder of a one-person limited liability company is unable to prove that the property of the one-person limited liability company is independent from his own property, he shall bear joint liabilities for the debts of the company".(Artical 63)

Such provision was needed in order to prevent company's over-control and evasion of creditors' debts. According to article 63, in case of confusion between the OPC property and the private property of s the shareholder's, the burden of proof is on the shareholder if confusion is to be clarified and veil piercing avoided. Nevertheless, unlike the general provision, article 63 facilitates the veil piercing for the OPC shareholders by providing them with additional solutions.

2.2 Bill to Revise the Company Law

" Where a shareholder of a company evades the payment of its debts by abusing the independent status of legal person or the shareholder's limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liabilities for the debts of the company.

If the shareholder of the company uses two or more companies under its control to commit the act prescribed in the preceding paragraph, each company shall be jointly and severally liable for the debts of any of the other companies".

2.3 Civil Code

"An investor of a for-profit legal person shall not damage the interests of the legal person or any other investor by abusing the rights of an investor.If the investor abuses the rights of an investor,causing any loss to the legal person or any other investor,the investor shall assume civil liability in accordance with the law.

An investor of a for-profit legal person shall not damage the interests of a creditor of the legal person by abusing the independent status of the legal person and the limited liability of the investor.If the investor abuses the legal person's independent status or the investor's limited liability to evade debts, causing serious damage to the interests of a creditor of the legal person,the investor shall be jointly and severally liable for the legal person's debts".

In conclusion, it should be observed that the statutory remedies developed in China are highly innovative. These remedies relay on general concepts such as "abuse",although their application is subject to the judicial practice and interpretation. In particular, as has already been seen in the past, the interpretations of the Supreme People's Court might be clarifying.

3. Typical Cases

The development of veil piercing doctrine by the Chinese jurisprudence is relatively recent. Roughly, it should be noted that Chinese judges tend to tighten the interpretation of the law by a literal interpretation. The main difficulties the jurisprudence seems have met so far include the right definition of abuse, that – as it shall be seen in the following sections – could take different forms depending on the case.

3.1 Li Mou v. B Education Company and Tian Moumou

Commingling or confusion of asset business or personnel represents the most common case of veil piercing in China. This case was well recognized even by the Supreme People Court : Li Mou v. B Education Company, Tian Moumou issued in 2017 .

The court held that China implements a real-name system for bank accounts, and the owner of the account is the owner of the funds in the account. There are a large number of frequent capital transactions between the accounts of B Education Company and the accounts of Xiao XX, Song XX and other shareholders, and the use of funds is complicated, which makes it impossible to distinguish between the company's property and the shareholder's property. Due to the confusion of property between B Education Company and its shareholders, the company has lost the basis for independently assuming debts. At the same time, Xiao XX and Song XX withdrew from B Education Company during the litigation period of this case, causing the company to become a one-person limited company (Tian XX as a shareholder). The above circumstances have seriously damaged the interests of creditors. According to Article 20 of the Company Law, "Where any of the shareholders of a company evades the

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payment of its debts by abusing the independent status of legal person or the shareholder's limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liabilities for the debts of the company”[2].

3.2 XX v. XX Equipment Company and XX Technology Company

In this case, without the consent of the shareholders meeting, a shareholder of XX Equipment company took advantage of its absolute control over XX Technology company to transfer an important customer of the subsidiary to its own name , causing the subsidiary to pay the decline in debt capacity, which in turn impairs the compensation of creditors’ rights of subsidiaries. Therefore, XX Equipment company should bear several and joint liabilities for the debts of XX Technology company[3].

In judicial practice, piercing the corporate veil cases are simply identified as involving excessive control, and there are still few cases of abuse of corporate control. The ambiguity and uncertainty of the judgment criteria for excessive control make many judges hard to make the decision.

The following factors should be considered comprehensively: (1) The shareholder has exercised dominant and absolute control over the subsidiary company;(2)This control behavior has no legitimate purpose and has subjective faults; (3)Damage is causal.

3.3 China Orient Asset Management Co Ltd v The Xi’an High-Tech Area Branch of China Construction Bank

China judges seemed reluctant to use undercapitalization as a ground to disregard limited liability. However, some court cases have offered important insights to outline this form of abuse. One of this is the case of China Orient Asset Management Co Ltd v The Xi’an High-Tech Area Branch of China Construction Bank[4]. Here the appellant Court gave a restrictive definition of undercapitalization.

In the said case, China Construction Bank provided a loan to Jinling Co. Jinling,which did not fulfil its obligation and failed to pay it back. Afterwards the debt was transferred to another company, namely China Orient Asset Management Co Ltd. (the plaintiff). This latter claimed that some shareholders of the Jinling Company had compromised the capital of the corporation, by making false contributions and withdrawing a large quantity of money, thus impeding the company to pay its debts.

The Court of first instance ruled in favour of the plaintiff, and applied article 20(3) of Company Law, in order to disregard the limited liability of Jinling's shareholders. Nevertheless, the Appellate Court reverted the verdict. The Court motivated its decision on the ground that Article 20 could not apply to the case at hand. Indeed, Chinese legislation accommodates only for a restricted definition of undercapitalization that would allow veil piercing. Undercapitalization raising from the comparison between the existing capital and the minimum capital stated by law is no pre-requisite. Instead, one should consider the comparison between the actual capital of the company and the risks of the company business. Only if the first is much lower than the latter, is there an undercapitalization that could serve as a pre-requirement to pierce the corporate veil.

3.4 Ying XX v. Shanghai J Trading Company, Chen XX

According to Article 20 of the Company Law, “If the shareholder of a one-person limited liability company is unable to prove that the property of the one-person limited liability company is independent from his own property, he shall bear joint liabilities for the debts of the company”. The above legal provisions require shareholders of a one-person limited liability company to strictly separate company property from personal finance, and shareholders should bear the burden of proof as to whether their personal property is separated from company property. In this case, Chen XX provided the relevant audit report of the appellant Shanghai J Trading Company, which can reflect that Shanghai J Trading Company has an independent and complete financial system.Shanghai J Trading Company’s property is separated from Chen XX’s personal property[5].

Whether the property of a one-person company is mixed with the shareholder’s personal property should be comprehensively considered whether the company has established an independent and standardized financial system, whether the financial payment is clear, and whether it has an independent business place.

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4. Common Scenarios of Piercing Corporate Veil

The shareholders of the company have committed the abuse of limited liability,which is an essential requirement for the application of the rules of piercing the corporate veil, mainly in response to the following abuses: commingling or confusion of assets, business or personnel; excessive dominance and control; undercapitalization, etc.

4.1 Commingling or Confusion of Assets, Business or Personnel

The following factors should be considered comprehensively: (1) Shareholders use company funds or properties for free without making financial records; (2) Shareholders use company funds to repay shareholders' debts, or use company funds or uses it for free without making financial records; (3) The company's account books are not separated from the shareholder's account books, making it impossible to distinguish the company's property from the shareholder's property; (4) The shareholders' own profits are not distinguished from the company's profits, making the interests of both parties unclear; (5) The property of the company is recorded in the name of the shareholder, and is owned and used by the shareholder; (6) Other situations where personalities are mixed.

The following confusion often occurs at the same time: company business and shareholder business are mixed; company employees are mixed with shareholder employees, especially financial personnel; company domicile is mixed with shareholder domicile. However, in practice cases, when the people's courts hear cases, the key to review is whether there is confusion of property, and it does not require confusion in other aspects at the same time. The confusion in other aspects is often only the reinforcement[6].

4.2 Excessive Dominance and Control

Excessive domination and control refers to the excessive domination and control of the company by the actual controlling shareholders of the company, manipulating the company's decision-making process, causing the company to completely lose its independence, without independent meaning and independent property. The common situations of excessive domination and control include: (1) Transfer of benefits between the parent company and the subsidiaries or between the subsidiaries; (2) Transactions between the parent company and the subsidiaries; (3)Withdrawing funds from the original company, and then establishing a company with the same or similar business purpose to avoid the debts of the original company; (4) Dissolving the company first, and then reusing the original company.Establishing another company for the same or similar purpose of operation in order to evade the debts of the original company.

However, in judicial practice, piercing the corporate veil cases are simply identified as involving excessive control, and there are still few cases of abuse of corporate control. The ambiguity and uncertainty of the judgment criteria for excessive control make many judges hard to make the decision[7].

4.3 Undercapitalization

Undercapitalization refers to the obvious mismatch between the amount of capital actually invested by shareholders and the risks implied in the company's operation during the course of operation after the company is established. Shareholders use less capital to engage in operations beyond their capabilities, which shows that they do not have the sincerity to engage in company operations. In essence, it is a malicious use of the company's independent personality and limited liability of shareholders to transfer investment risks to creditors. However, there is currently no clear stipulation on the criteria for the identification of undercapitalization, that is, capital that does not meet the company's operating risks.Given that there is no minimum capital requirement in the Company Law, in judicial practice, it is more common to use undercapitalization together with other factors as piercing the corporate veil[8].

5. Piercing the Corporate Veil in the the United States

It should be stressed how the main legal sources for veil piercing in US is the jurisprudence. The jurisprudences in each state seem have outlined similar standards for veil piercing. However, as far as

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the law is concerned, compared to other counties, in US -as a federal and common law system – might raise the issue about which law should be applied in case of veil piercing. This is the commonly known issue about the choice of law. To solve it, one should bear in mind how most of US companies are formed in accordance with state laws rather than national law.

Having said that, two are the main principles dealing with veil piercing conflict of law and that have been outlined by the US jurisprudence, namely the internal affair doctrine and the so-called paramount interest doctrine.

According to the internal affair doctrine for those disputes related to internal affairs of the corporation, should be applied the law of the state where the corporation has been incorporated. In this regard it is important to understand whether issues such as veil piercing might be included in the concept of "internal affair". Most of US courts seem answered positively to this latter query, thus most of courts have upheld the application of the law where the company was incorporated as the main criterion to solve the conflict of law related to veil piercing.

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Another approach carried out by some courts - especially in New York - is that one called of the paramount interest. The said doctrine advocate that "the law of the jurisdiction having the greatest interest in the litigation will be applied and . . . the facts or contacts which obtain significance are those which relate to the purpose of the particular law in conflict". Therefore, in this case the law to be applied is that one of the jurisdictions that have the greater interest to see its policy accomplishe.In conclusion, the applicable law for veil piercing in US might depends about different factors and doctrines, however, in most of case it is used the corporate laws of the states rather than the national one. In this regard noteworthy is even an interesting way veil piercing has been used in US, namely the so called "jurisdictional piercing".According to this concept, the disregard of corporation existence might make shareholders subjected to their personal jurisdiction rather than the jurisdiction of their corporation. This original outcome of veil piercing involves the application of the law.

6. Results and Discussion

6.1 Acts of Confusion between the Personalities of Shareholders and the Corporation

Starting from the first type of acts, personalities confusion can be generally considered as one of the most common phenomena that have been taken into consideration by theories about veil piercing. It can be argued that, under most of the US jurisprudence, and in this case the alter ego doctrine, confusion might occur when the interest and ownership of shareholders and corporation can be considered the same, and thus their personalities are no longer separate. This confusion must be clearly the outcome of shareholder's power to control and dominate the corporation. However, this precondition itself is not sufficient to disregard shareholder's limited liability since the instrumentality doctrine made additional pre-conditions. As well as domination, control and confusion, the defendants shall prove how the shareholder's conduct is able to create an inequitable result or that "circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice". The methodology of veil piercing found by the US jurisprudence seems able to include several cases, however the occurrence of interest and ownership confusion is a required precondition[9].

In this regard, it might be argued that a similar approach has been carried out even by the Chinese jurisprudence through the application of article 3 (1) of the Company Law of the People's Republic of China, which states the independence status of the corporation. For instance, from the Guiding Case No. 15 issued by the Chinese Supreme People's Court, it was pointed out the idea that assets confusion provokes the lack of corporate independent status, and liability cannot be enjoyed independently anymore. Nevertheless, this latter application of article 3 (1) of Company Law seems rare and it is often implemented together with other provisions. Nonetheless, the case of assets confusion is mainly addressed by Chinese jurisprudence through the application of article 20 (3) of the Company Law.

6.2 Acts of damage to creditors' interests

This can be observed for instance in the US instrumentality doctrine which provide a general reference to the "commission of a fraud" or "promotion of an injustice". However, these two facts shall be met together with a further prompt, namely the unity of interest and ownership between shareholder and corporation such as to bring the irrelevance of their existence before the law. In the Chinese system instead, this wider application relay generally on the shareholder's act of abuse of the "independent status of the corporation or its limited liability" in order to "evade debts" and "seriously harms the interests of the creditors of the company" (article 20 (3) of the Company Law). In accordance with the jurisprudential and doctrinal point of views, the interpretation of the aforementioned evasion of debts and the resulting serious damages, might be under the form of a fraud in order to avoid contractual obligations, or legal obligations.

6.3 Acts which induce the undercapitalization of the corporation

Roughly speaking, all the analysed systems found it difficult to accept undercapitalization as a pre-requirement for veil piercing. This aversion, especially of the jurisprudence, seems to be due to a difficulty in measuring the seriousness of the occurred undercapitalization, and fixing a threshold after which shareholders shall be considered liable.

Similar restrictive approach is carried out by Chinese courts. In this regard interesting is the attempt of some jurisprudence to outline the only type of undercapitalization that might justify veil piercing. For instance, in China Orient Asset Management Co Ltd v The Xi'an High-Tech Area Branch of China Construction Bank (2010) the appellant Court gave a restrictive definition in order to justify the application of article 20. Indeed, within the concept of abuse of the independent status of the corporation and limited liability of the shareholders, cannot be included the undercapitalization that raise from the comparison between the existing capital and the minimum registered capital stated by law, but rather the comparison between the actual capital of the company and the risks of the company business.

7. Conclusion

The arising problem is to define what is meant by abuse of limited liability or of the corporate form, which is the precondition to pierce the corporate veil. However, definitions of this kind can sometime remain too generic and might leave rooms for the jurisprudence to decide on a case-by-case basis, just as it is today in most of systems. Therefore, an alternative solution to that one based on providing definitions of abuse, is to outline a case groups list which, although generically shaped, could facilitate the judges in the application of veil piercing and better satisfy the need of certainty of the law for the investors and the community as a whole. These case groups should be developed in accordance with criterions related to public interest, justice and fairness. Some doctrine and jurisprudence have already tried to make this kind of lists which in most of cases include: assets, business, personnel confusion; undercapitalization; undue control; avoidance of contract obligation; avoidance of legal obligation.

In conclusion, a right balance should be found between the simultaneous presence of limited liability and the practice of piercing the corporate veil, where the first one represents the general principle in accordance to shareholders' interests, whereas the latter is an exception to the general principle, in accordance with creditors and external parties' interests. In order to balance veil piercing a solution might be the elaboration of hypothetical classifications and definitions of abuse in accordance with the public interest, and the principles of fairness and justice.

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