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Research on Personality Denial of Affiliated Companies

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Abstract: *In the form of affiliated companies, although each company is independent in form, due to the existence of equity or agreement control between each other, affiliated companies are more likely to abuse limited liability to harm the interests of creditors compared to general company forms. This article takes the 15th Guiding Case issued by the Supreme People's Court as the starting point to analyze the disputed issue of personality denial of affiliated companies in judicial practice.*

Keywords: *Affiliated Companies, Personality Denial, Recognition Criteria*

1. Introduction

With the continuous development of the market economy and the complexity of company structures, investors are constantly investing in establishing multiple companies to achieve maximum economic benefits. This means that the term "affiliated company" has emerged in the public's view. Although the emergence and development of affiliated companies have reduced transaction costs and improved transaction efficiency, there has also been a phenomenon of confusion in the personality of affiliated companies, disrupting normal business order and damaging the legitimate rights and interests of creditors. How to protect the interests of creditors by denying the independent personality of affiliated companies has become a problem that needs to be taken seriously in judicial practice.[1] Article 20 (3) of the Company Law stipulates the system of denial of corporate personality, which is limited to the typical case of shareholders abusing the independent personality and limited liability of the company, and lacks a legal basis for the denial of corporate personality of affiliated companies. Although Article 21 of the Company Law (Revised Draft) (First Draft) and Article 23 of the Company Law (Revised Draft) (Second Draft) have improved the system of corporate personality denial, they recognize that affiliated companies also apply the system of corporate personality denial in legislation, providing a legal basis for the denial of corporate personality of affiliated companies. However, the revised regulations are still not specific and clear enough, and there are still many problems in the application of the system of denying the legal personality of affiliated companies in practical disputes, such as the unclear definition of the concept of affiliated companies and inconsistent application conditions of the standards for determining the personality of affiliated companies. This article conducts research and analysis on relevant issues, constructs and improves the standards for determining the personality denial of affiliated companies, and unifies the application conditions and judgment standards of the rule of personality denial of legal persons by people's courts.[2]

2. Basic Case of Supreme People's Court's Guiding Case No. 15

The plaintiff, XCMG Construction Machinery Co., Ltd. (hereinafter referred to as "Xugong Machinery Company"), sued the defendant, Chengdu Chuanjiao Industry and Trade Co., Ltd. (hereinafter referred to as "Chuanjiao Industry and Trade Company"), for failing to pay the payment for goods, while Chengdu Chuanjiao Construction Machinery Co., Ltd. (hereinafter referred to as "Chuanjiao Machinery Company"), Sichuan Ruilu Construction Engineering Co., Ltd. (hereinafter referred to as "Ruilu Company") and Sichuan Jiaogong Industry and Trade Company have the same corporate personality. The personal property of the actual controller of the company, Wang Yongli, and the shareholders of Chuanjiao Industry and Trade Company are mixed with the company's property, and the three defendants should bear joint and several liabilities for repayment to XCMG Machinery

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Company. XCMG Machinery Company requests the court to order: 1. Chuanjiao Industry and Trade Company to pay the outstanding payment and interest; 2. Individuals such as Chuanjiao Machinery Company, Ruilu Company, and Wang Yongli shall bear joint and several liabilities for the repayment of the above-mentioned debts. After the court hearing, it is deemed that the personnel, business, finance, and other aspects of affiliated companies are overlapping or mixed, resulting in the inability to distinguish their respective assets and the loss of independent personality, which constitutes personality confusion. If the interests of creditors are seriously damaged, affiliated companies shall bear joint and several liabilities for external debts between themselves. The first instance court ruled that Chuanjiao Industry and Trade Company paid the goods and overdue payment interest to XCMG Machinery Company; Chuanjiao Machinery Company and Ruilu Company shall bear joint and several liabilities for the above-mentioned debts of Chuanjiao Industry and Trade Company. In the second instance court rejected the appeal and upheld the original judgment.[3]

The 15th guiding case involves the identification of personality confusion in affiliated companies. This guiding case fully demonstrates the guiding role of the guiding case in case adjudication and to some extent fills the legal loopholes. In this case, the court mainly relied on the confusion of personnel, business, and finance as the basis for determining "personality confusion". This case further clarifies the basis for determining the "personality confusion" of affiliated companies, as well as the legal consequences that constitute "personality confusion". It is conducive to guiding the company to maintain independence in personnel, finance, business, and other aspects in the process of operation and management, avoiding personality confusion, and thus curbing the abuse of legal personality, independent status of legal persons, and limited liability of shareholders.

3. Difficulties in Determining Disputes over the Denial of Corporate Personality of Affiliated Companies in Practice

3.1 Lack of Judgment Basis

In judicial practice, the laws on which court judgments are based vary. After the Supreme Court issued the 15th Guiding Case in 2013, it can be seen from the judgment that there were direct citations of Article 3 or Article 20 (3) of the Company Law in the trial, some referring to the application of Article 20 (3) of the Company Law, and some directly using the 15th Guiding Case as a reason for judgment. In the 15th guidance case, it is shown that personnel, property, and business are the three key identification criteria, and whether personnel, property, and business are mixed has become the basis for many court judgments. However, in the reasons for the judgment, some cases have provided detailed explanations on whether personnel, property, and business are mixed, while others have not been clearly explained. Some courts may use relevant principled clauses and legal theories as the reasons for the judgment.

Article 20, Paragraph 3 of the Company Law: "If a company's shareholders abuse the independent status of the company's legal person and the limited liability of shareholders, evade debts, and seriously harm the interests of the company's creditors, they shall bear joint and several liabilities for the company's debts." This provision is a direct and complete regulation of the system of denial of legal person personality, including provisions on the constituent elements and legal effects of denial of legal person personality, and can directly and independently serve as the basis of a claim. However, Article 20 (3) of the Company Law stipulates the most traditional situation of denial of corporate personality - "vertical denial of corporate personality", which means that in the same company, the independent personality of the company is denied, and the company and specific shareholders of the company are jointly and severally liable to creditors. Therefore, the personality denial system stipulated in China's current company law does not directly include horizontal legal personality denial, which leads to disputes in judicial practice and academic circles regarding the legal application of such cases.

3.2 Unclear definition of the related company concept

In terms of legislation, there are two main definitions and regulations for affiliated companies: firstly, from the perspective of the market or legal entity, it is believed that affiliated companies are a group of independent companies that form a relatively independent market or legal entity. Affiliated companies are responsible to external creditors as a whole. The second is from the perspective of the specific relationship between companies, which believes that affiliated companies are a community of shared future formed by several legally independent companies through mutual control, subordination, or investment relationships between companies.

As a legal concept, "affiliated enterprise" was first seen in the 1991 Foreign Investment Enterprise and Foreign Enterprise Income Tax Law and its implementation rules. Article 52 of the implementation rules: "Affiliated enterprise" mentioned in Article 13 of the tax law refers to companies, enterprises, and other economic organizations that have one of the following relationships with the enterprise: (1) they have direct or indirect ownership or control relationships in terms of funds, operations, purchase, and sales, etc; (2) Directly or indirectly owned or controlled by a third party; (3) Other relationships related to interests. There is no clear definition of affiliated companies in China's Company Law. In Article 216 (4) of the Company Law, affiliated relationships are defined as The relationship between the controlling shareholders, actual controllers, directors, supervisors, and senior management of a company and the enterprises they directly or indirectly control, as well as other relationships that may lead to the transfer of company interests. However, state-owned enterprises not only have related relationships because they are both controlled by the state. There is a lack of legal regulation on related companies in China. Article 216 (4) of the Company Law stipulates that this provision involves some paths for establishing affiliated relationships. Due to the imperfect provisions of the affiliated company system in China's Company Law, this provision only addresses the issue of controlling shareholders, actual controllers, directors, supervisors, and senior management personnel using affiliated relationships to encroach on the interests of the company, and does not involve situations where affiliated companies infringe on the interests of company creditors, The issue of affiliated companies assuming external responsibility as a whole. The proviso to this provision explicitly excludes the fact that holding state-owned enterprises do not form an affiliated relationship based on the characteristics of state-owned enterprises in China. In short, state-owned enterprises have their characteristics and cannot be recognized as affiliated companies based on investment relationships Due to the lack of a clear definition of affiliated companies, there are differences in the judgment standards for identifying affiliated companies among courts at all levels in judicial practice.

3.3 Inconsistent Application Requirements of the Criteria for Determining the Personality Denial of Affiliated Companies

In judicial practice, there are differences in the elements of determining the identity of affiliated companies, and the application conditions and judgment standards of the rule of denying the personality of legal persons vary among people's courts. According to Article 20 (3) of the Company Law, the applicable requirements of the system of disregard of corporate personality include one element of behavior, which is the abuse of independent corporate personality by shareholders and the limited liability of shareholders. There are differences in the elements of identifying personality confusion. In judicial practice, the main elements of identification include personnel confusion, business confusion, and property confusion. The main standard for the court to determine in its judgment is property confusion, and personnel confusion or business confusion does not necessarily constitute personality confusion. The second is the resulting requirement, which is to evade debt and seriously harm the interests of the company's creditors. In judicial practice, most do not involve the determination of factors that "harm the interests of creditors".[4] There is no clear mention or elaboration on the determination of damages to the interests of creditors.

3.4 Unreasonable Allocation of Burden of Proof

According to the principle of "who claims, who provides evidence", the plaintiff needs to provide evidence for their claims. When the evidence he provides makes the facts he claims unclear, he still bears the responsibility of not being able to provide evidence. In personality denial disputes, the burden of proof is generally borne by the creditor as the plaintiff. However, as an outsider of the company, especially an affiliated company, it is very difficult to fully grasp the evidence of shareholders abusing the company's independent personality within the company. The controlling shareholders of affiliated companies control the company, and external creditors have little knowledge of the company's information. The burden of proof is too strict for creditors, which is not conducive to restraining shareholders from abusing the company's position. In judicial practice, the problem is even more prominent. In most cases, the plaintiff's creditors are located outside the target company, making it difficult to obtain relevant evidence such as internal assets, accounts, contracts, etc. It is difficult to complete effective evidence of confusion between shareholders and the company's personality, thus falling into a losing position.[5]

4. Improve the System of Personality Denial for Affiliated Companies

4.1 Improving the Judgment Basis for Related Companies

The most reasonable solution for determining the basis for denying the personality of affiliated

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companies is to refer to Article 20 (3) of the Company Law. Article 20 (3) points out that shareholders disregard the independent personality of the company, mix shareholder behavior with company behavior, and do not separate shareholder property from company property, seriously damaging the interests of company creditors. Similarly, affiliated companies guarantee the independence of property and personality in their existence and operation. If personnel, business, property, etc. are mixed and there is no division between them, they lose their independent status. At this time, if the interests of creditors of a certain company are seriously damaged, they have the right to claim joint and several liabilities of affiliated companies. The normative purpose of these two types of cases is the same, both are based on the fact that the company's personality no longer exists, extending the company's responsibility to other subjects who are confused with the company's personality. Therefore, the application of Article 20 (3) in the case of personality denial of affiliated companies is in line with the purpose of legal norms.

4.2 Clear Definition of Affiliated Companies

Affiliated companies can be established vertically or horizontally. Affiliated companies established through vertical investment relationships often have one-way control, that is, the control of superior companies over subordinate companies. Typical examples are the relationship between parent and subsidiary companies, as well as the relationship between the company and the holding company. Through horizontally established affiliated companies, the control between companies is not a one-way control and subordination relationship but may be mutual control and subordination Belonging to relationships, typically involving mutual investment, cross-shareholding, mutual retention of board seats or mutual dispatch of senior executives, as well as other coordination or control relationships established through contracts.

Whether it is a vertically established affiliated company, a horizontally established affiliated company, or an affiliated company with both control methods, they have some common characteristics, that is, the actual existence of control and subordination relationships or mutual control relationships between affiliated companies. This control and subordination or mutual control relationship is continuous and frequent and is a management system that exists between affiliated companies. The overall interests of affiliated companies include unified organization, concerted action, cooperation, and connection, and the controlled members in affiliated companies may lose their independent personality and will. A one-time or accidental control arising from the performance of a contract or other relationship does not constitute an affiliated company. The control of affiliated companies is generally reflected in personnel control, financial control, and business operation control. For example, the controlling company appoints senior executives such as directors and managers of affiliated companies; Mutual control companies reserve board seats for each other; The controlling company is responsible for overseeing finance and arranging profit transfers to evade taxes; Controls the company's unified arrangement and scheduling of business operations, so that subordinate companies engage in unconventional or unprofitable operations.

In practice, the most common affiliated companies that involve the denial of legal personality are parent-subsidiary companies, multiple subsidiaries or participating companies controlled by the same controlling shareholder, subsidiaries controlled by the same controlling shareholder, and subsidiaries controlled by relatives of the controlling shareholder. Suggestion to refer to Article 109 of the Implementation Regulations of the Enterprise Income Tax Law: "The term 'related party' referred to in Article 41 of the Enterprise Income Tax Law refers to an enterprise, other organization or individual that has one of the following related relationships with the enterprise: (1) has a direct or indirect control relationship in terms of funds, operations, purchases, and sales; (2) is directly or indirectly controlled by a third party; (3) has other related relationships in terms of interests The definition of affiliated companies is clear, that is, affiliated companies can be identified from the control and subordination relationship or interest relationship between affiliated companies, and related party transaction can be standardized from the perspective of the related relationship and related behavior. It not only focuses on the objective holding relationship, but also pays attention to the indirect control relationship, not only limited to regulating the controlling shareholders, directors, supervisors, executives, and the enterprises controlled by them, but also the actual controllers and the enterprises controlled by them, not only regulating affiliated enterprises but also regulating affiliated personnel.

4.3 Applicable Requirements for Unified Recognition Standards

Article 11 (2) of the "Minutes of the National Conference on Civil and Commercial Trial Work of Courts" (hereinafter referred to as the "Nine Minutes of the People") stipulates that: If a controlling shareholder or actual controller controls multiple subsidiaries or affiliated companies, abuses control power, causes unclear property boundaries, financial confusion, the mutual transmission of interests, loss of personal independence, and becomes a controlling shareholder evading debt, illegal business operations, or even illegal criminal tools, the legal personality of the subsidiary or affiliated company can be denied based on the facts of the case, and joint liability can be ordered. The fundamental criterion for determining whether there is confusion between the personality of a company and that of its shareholders is whether the company has independent will and independent property. The Supreme Court's Guiding Case No. 15 also points out that whether property is mixed is a substantive factor in determining whether affiliated companies have personality confusion. Whether the legal personality of affiliated companies can be denied depends on whether the affiliated companies have mixed personalities, and whether the degree of personality confusion among affiliated companies has reached a level that seriously damages the interests of creditors. Furthermore, the key to the confusion of personality among affiliated companies lies in whether their assets are mixed. When determining, the following factors should be comprehensively considered: shareholders use the company's funds or assets without recording; Shareholders use company funds to repay shareholder debts, or use company funds for free use by affiliated companies, without recording; The company's books of account are indistinguishable from the shareholders' books, making it impossible to distinguish between the company's assets and the shareholders' assets; The shareholders' profits are indistinguishable from the company's profits, resulting in unclear interests for both parties; The company's assets are recorded in the name of shareholders and are owned and used by them; Other situations.[6]

When judging property confusion, attention should be paid to a comprehensive analysis of factual evidence, and only to the extent that companies cannot distinguish their respective properties is sufficient to constitute it. For the judgment of financial confusion, some courts tend to rely on a single fact to determine, and its caution is worth discussing. In cases of personality confusion, the following confusion often occurs simultaneously: confusion between company business and shareholder business; confusion between company employees and shareholder-employees, especially financial personnel; and confusion between company and shareholder residences. When the People's Court hears a case, the key is to examine whether it constitutes personality confusion, without requiring the presence of other aspects of confusion at the same time. Other aspects of confusion are often just reinforcement of personality confusion, Personnel confusion, business confusion, and residence confusion are only accompanying factors of personality confusion. The key to determining personality confusion is to determine whether their property is mixed or not, without requiring all other factors of confusion to be prepared. Other aspects of confusion are often just reinforcing factors of personality confusion. In essence, the fundamental criterion for determining whether a related company constitutes personality confusion is whether the company has independent will and independent property. Regarding the degree of "confusion", the substantive standard is still to return to Article 20 (3) of the Company Law, which stipulates the degree of "abuse" of rights. The behavior of "abuse" often has a certain degree of persistence and repetition, so it is inappropriate to identify it as abuse solely based on one-time behavior.

For the result element of serious harm to the interests of creditors, it is necessary to provide a detailed description of the specific elements that seriously harm the interests of creditors. The specific judgment criteria can refer to Article 2 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the Bankruptcy in China (I), that is, the creditor-debtor relationship is established by the law, the debt performance period has expired, the debtor has not fully paid off the debt, prudently review the company's assets, business conditions, etc., to see whether it has lost the ability to pay long-term debts, and if the creditor's rights have security measures, We also need to consider whether the security right can be realized, etc.[7]

4.4 Reasonably Allocating the Burden of Proof

According to Article 7 of the "Several Provisions of the Supreme People's Court on Evidence in Civil Litigation", considering the serious imbalance in the ability of both parties to provide evidence in the related company personality denial lawsuit, the plaintiff shall bear the preliminary burden of proof and shall provide surface evidence that the independence of the company's personality no longer exists or has been abused. As the creditor of the plaintiff, they have provided probable evidence to prove that the shareholder has abused the independent status of the company's legal person and the limited liability of the shareholder, as well as the resulting damage. Then, the defendant is required to prove that they have not abused the company's personality, and if they cannot provide evidence to prove it, they will bear adverse consequences.

In a lawsuit of corporate personality confusion, the burden of proof for the confusion between shareholders and the company's financial personality, as well as the confusion between affiliated companies, should be borne by the company's creditors in principle. However, as external creditors, it is difficult for company creditors to obtain some information. According to the principles of fairness and good faith, as long as the company's creditors can provide preliminary evidence to prove that the shareholders intentionally abused the company's independent status and limited liability, as long as the company has significant insufficient capital, excessive control, mixed personality (including property, business, and personnel), and distorted company personality, And it is proven that this has caused damage to its interests. If the evidence of the creditor raises reasonable doubts, the court will allocate the burden of proof that has not been abused to the sued shareholders and the company, and the shareholders and the company will provide evidence to eliminate reasonable doubts.

But this is not a natural reversal of the burden of proof. If the evidence presented by the creditor cannot reach a level sufficient to reasonably doubt the confusion of personality, the inversion of the burden of proof cannot be applied. It is necessary to provide sufficient evidence to preliminarily prove that there is a possibility of confusion between legal persons, so that the burden of proof can be reversed, and the court will require the defendant to provide internal information such as financial books and contracts by its authority. If there is any unreasonable flow and loss of company assets in the accounting books, especially suspicious situations where transfers are made directly from company accounts to shareholder accounts or from one affiliated company to other affiliated company accounts without financial records, the judge will require the accused shareholder and the company to explain. If the sued shareholder and the company cannot provide a reasonable explanation to prove that there is no confusion between their personal property and the company's or affiliated company's property, the company shall be deemed to have lost its independent legal personality, and the sued shareholder and the company shall be jointly and severally liable for the company's debts.

5. Conclusion

In summary, there are a large number of cases in practice where the personality of affiliated companies is mixed and harms the interests of creditors. According to the Supreme People's Court's Guiding Case No. 15, although it is possible to solve practical difficulties and try to achieve the same judgment in the same case, the law still needs to respond to the needs of practice by providing more detailed provisions for the system of denying the personality of legal persons, or regulating it through judicial interpretation, so that the court can achieve fairness in the judgment process of individual cases When applying the system of denying the legal personality of affiliated companies, it is necessary to strictly grasp the applicable requirements and make a comprehensive judgment based on the behavioral and outcome requirements, that is, to determine whether there is personality confusion between affiliated companies and whether the behavior of personality confusion seriously damages the interests of company creditors.

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