

# Empirical Study of the Reverse Piercing of the Corporate Veil

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**Abstract:** *This paper presents the results of the empirical study of China's cases of reverse piercing of the corporate veil. The empirical study shows that: the rate of support for reverse piercing is low, the piercing application standards are different, and the basis of judgement is complex and varied. The main reason for such problems is that the current company law in China lacks the basis for the judgement of reverse piercing of the corporate veil; the applicable standards are unclear; and it is difficult to balance the interests of shareholders and creditors, the company and its stakeholders. This article is intended to draw on the practice and experience of the U.S. reverse corporate veil piercing system and make suggestions for the construction of a reverse corporate veil piercing system in China. In the future, the company law should be revised and judicial interpretations should be formulated to establish a direct normative basis for reverse piercing of the corporate veil; the application standards should be clarified, and a mechanism for coordinating relevant interests should be constructed.*

**Keywords:** *reverse piercing of the corporate veil; applicable criteria; balance of interests; empirical studies*

## 1. Introduction

Reverse legal personality denial, also known as reverse piercing of the corporate veil, refers to the reverse denial of a company's independent personality in special circumstances, so that the company is jointly and severally liable for the personal debts of its shareholders. Reverse veil piercing also includes two types: one is the company itself or the company's shareholders actively seeking to pierce the corporate veil, so that the company can enjoy the privileges or debt immunity that only the shareholders can enjoy, which is theoretically referred to as "insider reverse veil piercing". The other is the request of shareholders' creditors to pierce the corporate veil so that the company will bear unlimited joint and several liability for the shareholders' personal debts, which is known as "reverse piercing of the corporate veil by outsiders" (hereinafter referred to as "reverse piercing by outsiders") [1]. As reverse piercing of the corporate veil by an insider does not fit in with the concept of protection of creditors' interests emphasised in the veil piercing regime, this article only focuses on the study of reverse piercing of the corporate veil by outsiders.

The exploration of reverse piercing of the corporate veil is gradually emerging in judicial practice, and in the past, courts have handed down judgements on reverse piercing of the corporate veil against a backdrop of a lack of adjudicative basis. Can the provisions of Article 20 of the Company Law be applied to reverse veil piercing cases? Some scholars have argued that reverse piercing of the corporate veil should be a result of the veil piercing regime by interpreting paragraph 1 of Article 20 of the Company Law in accordance with interpretative standards. It is argued that as long as there are shareholders abusing the independent personality of the company for improper transfer of benefits, the company and the shareholders have essentially become a whole and should be jointly liable [2]. From the perspective of asset division theory, other scholars believe that it is necessary for the court to reverse pierce the corporate veil to a certain extent, and that the reverse piercing of the corporate veil system is a restriction on positive asset division. Reverse veil piercing can reduce the "asset substitution" costs caused by the positive asset division arrangement and promote fairness [3]. Judicial practice also supports the application of the rule of reverse piercing of the corporate veil. In the cases supporting reverse piercing of the corporate veil, due to the lack of a basis for judgement, the basis and rationale for the judgements of the courts are complex and varied, affecting the uniformity of judicial decisions. Through descriptive analysis of sample cases and analysis of typical individual cases, the current status of reverse piercing of the corporate veil trials can be found, and consensus and

disagreement can be found.

This paper argues that the research on the reverse piercing of the corporate veil system is divided into two aspects. One is from the practical level, from its practical needs, system value and other aspects, fully demonstrate the necessity of the existence of reverse piercing corporate veil system. The second is the theoretical level, analysing the problems to be faced in the process of constructing the reverse piercing corporate veil system and the solutions on how to solve them, so as to provide possible institutional paths for constructing the reverse piercing corporate veil system.

## 2. Empirical Analysis

### 2.1 Analysis of the Judgement

The author used the key words "reverse", "piercing", "uncovering", "personality", "denial", etc. to form different key phrases, search in the China Judgement and Documentation Network, No Lawsuit Cases, Beida Faber judicial case database. The time span of the cases obtained in the distribution of 2009-2022, excluding the focus of controversy has nothing to do with the reverse piercing of the corporate veil, the same case retained the final judgement, a total of 54 cases as the research of the sample cases. Among them, Table 1 shows that there are 16 cases that support reverse piercing and 38 cases that do not, with a piercing rate of 30.91%. This is much lower than the overall piercing rate of 63.64% in the 2012 study [4]. In the cases supporting reverse piercing of the corporate veil, the basis and rationale for court judgements are complex due to the lack of adjudicative basis (analysed in more detail below). In the cases that did not support piercing, the reason for the judgement was mostly "lack of corresponding legal basis".

Table 1: Court piercing rates

Form	Aggregate	Punctured	Puncture-free	Puncture rate
All cases	54	16	38	30.91%

### 2.2 Analysis of the Main Elements of the Judgement

#### ● Reasons for Adjudication in Favour of Piercing the Corporate Veil

Traditional grounds for piercing the corporate veil include confusion of personality, significant undercapitalisation, fraud or misconduct, and excessive domination and control [5]. In the cases in favour of reverse piercing of the corporate veil, the grounds of decision in favour of piercing, conflation of personalities is the most important ground of decision, and the constitutive elements of conflation of personalities are expressed differently in each judgement. As for the result element, it is seldom mentioned in the cases supporting the reverse piercing of the corporate veil, and even if it is mentioned, it is just a sentence without detailed argumentation.

#### ● Legal Basis for Adjudication

Article 20 of the Company Law, as a general provision on piercing the corporate veil, is principled and abstract, resulting in different conditions of application and standards of judgement of people's courts on piercing the corporate veil. In the cases supporting the reverse piercing of the corporate veil, some courts directly applied Article 20 of the Company Law as the basis for their decisions. It argued that the shareholders' abuse of the independent personality of the company for the purpose of unduly transferring benefits belongs to the typical shareholders' abuse of the independent status of the legal person and the shareholders' limited liability. Some courts directly applied the provisions of Article 23 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of Law in the Trial of Private Lending and Loan Cases (hereinafter referred to as the Private Lending and Loan Provisions), and Article 7 of the Provisions of the Supreme People's Court on Several Issues Concerning the Trial of Cases of Civil Disputes Relating to the Restructuring of Enterprises (hereinafter referred to as the Enterprise Restructuring Provisions). In the case of a one-person company, some courts directly applied Article 63 of the Company Law, holding that "a one-person limited liability company can apply the rule of reverse legal personality denial. Since the shareholders of a one-person limited liability company cannot prove that the company's property is independent of the shareholders' own property, it means that the shareholders' and the company's property are mixed, and in turn, both parties should be jointly and severally liable for each other's debts", and some courts explicitly stated that with reference to the viewpoint of the Supreme Court's Civil Ruling of MinShen

2158 (hereinafter referred to as Judgement Case No. 2518), they held that "In the case of one-person limited liability company, in the case of mixed personality of the shareholders and the company, the company can also assume joint and several liability for the debts of the shareholders". Some courts even applied Article 20 of the Provisions of the Supreme People's Court on Several Issues Concerning the Change and Addition of Parties in Civil Enforcement (hereinafter referred to as the Provisions of the Supreme Court on Civil Enforcement) as the basis for the decision of the one-person limited liability company's reverse piercing of the corporate veil. It can be seen that the reverse piercing of the corporate veil has fallen into the dilemma of confusing adjudication basis, reflecting the objective demand for the system of reverse piercing of the corporate veil in judicial practice, and there is an urgent need for research and application of the system.

### **3. Analysis of Divergence and Consensus**

#### ***3.1 The Need for a System of Reverse Corporate Veil Piercing***

The frequent cases of reverse piercing of the corporate veil in judicial practice, and the courts being caught in the dilemma of confusing the basis for decisions, reflect the objective demand for the reverse piercing of the corporate veil system in judicial practice, and the urgent need for research and application of the system. However, the construction of any new legal system should take into account not only the objective needs in judicial practice, but also the existence of alternative legal systems to the existing ones. Opponents of the reverse veil piercing system believe that equity enforcement procedures, creditor's right to rescind, employer's liability and agency law provisions can be alternatives to reverse veil piercing. The following regimes are analysed below.

##### ***3.1.1 Equity Enforcement Procedures***

Enforcement procedures for equity interests are no substitute for a reverse piercing corporate interview system. Firstly, the enforcement of equity must be limited to the equity held by the shareholders. Shareholders' creditors can only take preservation measures against the equity held by the shareholders rather than the company's property, and even if the enforcement of the equity is carried out, they will not be able to obtain full compensation. Secondly, in reverse piercing of the corporate veil cases, there are often cases where shareholders or actual controllers transfer personal property to the company, or where the parent company transfers assets or funnels benefits to subsidiaries. Equity enforcement presupposes that the debtee owns shares in the company, whereas in practice the actual controller may not be a shareholder.

##### ***3.1.2 Creditors' Right of Avoidance***

Creditors' right of avoidance can, to a certain extent, regulate the improper transfer of property by shareholders to evade debts, but it is still no substitute for the system of reverse piercing of the corporate veil. Firstly, it is difficult to define the nature of the shareholders' contribution to the company. Shareholders of the company's capital is a commercial investment or malicious transfer of property, need to have a perfect commercial judgement rules, there is no relevant rule base. Secondly, allowing shareholders and creditors to exercise the right of avoidance will seriously harm the interests of the company's creditors, increase the investment risk of the company's creditors, reduce the confidence of the company's creditors in the company, and trigger the company's potential creditors to raise the price of the transaction to offset the damages that may be brought about by the uncertainty risk[6].

##### ***3.1.3 Agency System***

Agency requires the existence of express, implied or constructive authority between the agent and the nominee, whereas normally there is no express, implied or constructive authority between the company and the shareholders. Moreover, "the agent has the obligation to obey his own instructions at all times in the performance of the act of agency", but in the case of abuse of corporate personality, the company is just a tool for the shareholders to make profits. "The agent in the agency behaviour is mainly for the interests of the nominee", while the abuse of corporate personality of the shareholders is mainly for their own interests. In sum, the agency system is not an effective substitute for the application of the reverse piercing of the corporate veil system.

In summary, in response to the judicial practice demand, theory and practice, for the construction of the reverse piercing of the corporate veil system has reached a greater consensus. Coupled with the fact that the existing legal system in China does not have a legal system that can be a suitable substitute for the reverse piercing of the corporate veil system, the construction of the reverse piercing of the

corporate interview system appears to be very necessary.

### ***3.2 Basis for Adjudication of the Reverse Corporate Veil Piercing Regime***

According to the empirical cases, it can be found that the current company law in China lacks the adjudicative basis for reverse piercing of the corporate veil. The basis for judgements is complex and varied. The courts' elastic understanding and application of the law will detract from the stability and predictability of the law and reduce its majesty.

With regard to the basis for adjudication of reverse piercing of the corporate veil, there are different propositions in the theoretical community, namely the expansive interpretation theory and the legislative theory. Among them, the interpretative theory refers to an expansive interpretation within the framework of the existing legal system, which applies to reverse piercing of the corporate veil by analogy from the textual meaning of the provisions. The legislative theory refers to the existing provisions associated with the reverse piercing of the corporate veil, due to their own defects, and cannot bear the burden of introducing the reverse piercing of the corporate veil system, it is necessary to seek legislative changes. At present, in the judicial practice, there are jurisprudence adopting the theory of expansive interpretation, such as Shenyang Huitian Cogeneration Co., Ltd. and Shenyang City Second Municipal Construction Engineering Co. The Court held that New Oriental owned 51% of the equity of New Oriental, and the mixing of personnel, management and capital between New Oriental and Huitian indicated that the legal personality of New Oriental had been morphed into an alter ego of Huitian. According to Article 20 of the company law on the denial of legal personality provisions of the proper meaning, the new Oriental company should be jointly and severally liable for the debts of its shareholders Huitian company. The basis of the decision is analysed below.

#### ***3.2.1 Article 20 of the Company Law***

Article 20(1) of the Company Law is an umbrella provision for the jurisprudence of reverse piercing of the corporate veil, regulating the abuse of corporate personality and limited liability of shareholders, and some scholars believe that as long as there are such behaviours, they should be included in the scope of the provisions of this paragraph[7]. However, there is a debate in the theoretical circles on the expansion of the interpretation theory. And some scholars believe that Article 20(1) and (3) of the Company Law explicitly state that the creditors to be protected here are the "creditors of the company", and that the interpretation which is completely detached from the meaning of the text has brought about a great deal of uncertainty in the interpretation and application of the law. It is difficult to use the expanded interpretation of the institutional arrangement of Article 20 of the Company Law as the institutional basis for the denial of reverse legal personality. Expanded interpretation of the law requires interpretation within the "range" of the text of the legal provisions[16]. Article 20 (1) and (3) of the Company Law clearly stipulate the applicable subjects and circumstances, and an expansive interpretation would be in conflict with the meaning of the text, and therefore Article 20 of the Company Law is not suitable to be used directly as a systematic basis for reverse piercing of the corporate veil.

#### ***3.2.2 Article 63 of the Company Law***

Article 63 of the Company Law, taking into account the one-person limited liability company, the shareholders and the company has a greater possibility of personality mixing, the shareholders were given a heavier duty of care, the burden of proof reversal system. It is not a complete denial of the one-person limited liability company's legal personality. It cannot be taken for granted that this provision contains the meaning of reverse piercing. Reverse piercing requires more factors to be considered in a balanced manner. In deciding on a reverse piercing case, the judge has to look for a balance between the interests of shareholders' creditors, bona fide shareholders of the company and the company's creditors[8].

#### ***3.2.3 Article 7 of the Enterprise Restructuring***

Article 7 of the Provisions on Enterprise Restructuring, whose scope of application is limited to restructured enterprises, and whose normative purpose is to prevent the loss of State-owned assets in the restructuring of enterprises, is of a policy nature and does not apply to companies established by the Company Law. It is not suitable for analogous application to reverse piercing of the corporate veil. The application of analogy, that is, the law in a case type (A) of the legal effect of the transfer of the provisions of the law in the case type (B)[9]. The application of analogy involves first exploring the normative purpose of a legal provision, and then deciding whether the principle of equality should be

applied to matters not regulated by other laws on the basis of the "same normative purpose"[10]. In the specific case of the application of analogy to Article 7 of the Provisions on Enterprise Restructuring, the first step is also to explore its legislative purpose, which is centred on regulating "restructured enterprises" and does not apply to ordinary private enterprises.

### ***3.2.4 Article 23 of the Private Lending Regulations***

Article 23(2) of the Provisions on Private Lending Regulations stipulates that: "Where the legal representative of a legal person or the head of an unincorporated organisation enters into a private lending contract with a lender in the name of an individual and the borrowed money is used for the unit's production and operation, and the lender requests that the unit and the individual be held jointly liable, the People's Court shall support the request." There is a gap between the scope of its applicable subjects and the reverse piercing of the corporate veil. First of all, empirical cases show that, in the case of reverse piercing the corporate veil, the parent-subsidiary company abuses the limited liability of shareholders and the independent personality of the company's legal person to carry out the improper transfer of benefits is more common. And the "private lending regulations", the subject of its application can only be natural persons, cannot solve the reverse piercing of the parent-subsidiary situation. Secondly, reverse piercing the corporate veil, refers to the company's shareholders to transfer property to the company to avoid personal debt, etc., according to the shareholders or creditors claim reverse piercing the corporate veil, by the company's shareholders of personal debt liability. In the Private Lending Regulations, the legal representative, the person in charge may not be a shareholder of the company, even if the company's representative, the person in charge of the company shareholders, to decide whether to pierce the key is to consider whether to meet the piercing of the behavioural elements and the results of the elements, etc. Applying the provisions of the Private Lending Regulations is not in line with the concept of the corporate veil-piercing system, nor with the one-time and relative character of the system[11].

In summary, China currently only has provisions related to piercing the corporate veil, and there are no direct provisions for reverse piercing of the corporate veil, but there are inherent logical deficiencies in the current corporate veil piercing norms under the current company law, which are unable to bear the burden of applying the law to cases of reverse piercing of the corporate veil, and the system of reverse piercing of the corporate veil should be sought to make a change in the legislation.

## ***3.3 Elements of Reverse Piercing of the Corporate Veil***

The central issue in piercing the corporate veil is how the courts consider the various grounds on which the veil is proposed to be pierced. Article 20 (3) states the main elements applicable to piercing the corporate veil are the subjective, behavioural and consequential elements, namely, the existence of "shareholders of the company", "abuse of the independent status of the company's legal person and the limited liability of its shareholders", "evasion of debts to the serious detriment of the interests of creditors" and "the abuse of the independence of the legal person and the limited liability of its shareholders". The court should take a comprehensive view of the cases of reverse veil piercing to find a delicate balance between the shareholders and creditors, the shareholders of the company and the creditors of the company.

### ***3.3.1 Subjective Elements***

The subject element of reverse piercing of the corporate veil is divided into two parts: the subject of rights and the subject of liability[12]. The subject of rights in a traditional piercing of the corporate veil refers to the creditors of the company, while the subject of rights in a reverse piercing of the corporate veil refers to the creditors of the particular shareholders of the company, including both voluntary and involuntary creditors of the shareholders. The subject of liability in a reverse piercing of the corporate veil refers to the company that is being used by the particular shareholders to evade its debts (hereinafter referred to as the "requested piercing company"). In judicial practice, the specified shareholders and the requested company always participate in the lawsuit as co-defendants.

### ***3.3.2 Behavioural Elements***

The sample cases show that the behavioural element of reverse piercing of the corporate veil is mainly confusion of personality, and that there is a lack of clarity as to how to identify confusion of personality. The discussion of the standards applicable to piercing the corporate veil has been the subject of fruitful research and regulation, and will not be repeated here.

### **3.3.3 Results Elements**

The result element is seldom mentioned in the cases in favour of reverse piercing of the corporate veil, and when it is mentioned, it is only in a single sentence without detailed argumentation. The traditional result element of piercing the corporate veil refers to the serious damage caused to the interests of the company's creditors by the shareholders' abuse of limited liability and the independent personality of the company's legal person. Unlike the traditional outcome element of corporate veil piercing, the practical criterion of the reverse veil piercing regime is the balance of interests [13]. The result element of the reverse veil piercing system should not only take into account the damage to the subject of rights or the public interest of the society, but also the damage to the interests of the innocent shareholders and the creditors of the responsible subject [14].

In summary, the criteria for applying the reverse piercing of the corporate veil regime can follow the traditional piercing three-element framework of "subject-act-result". However, the court should take a comprehensive view and find a delicate balance between the shareholders and creditors, the shareholders of the company and the creditors of the company.

## **4. Discussion**

### **4.1 Practice in the United States**

China's judicial practice of reverse piercing the corporate veil system has an urgent need, and the existing legal system can not replace its role, so the reverse piercing the corporate veil system of legal transplantation is imperative [15]. The theory of "piercing the corporate veil" was pioneered by Judge Sanborn in 1905 in the case of *U.S. v. Milwaukee Refrigerator Transit Co.*, which has become an important theory in U.S. corporate law. The relevant judicial practice and experience of the United States is of great significance to the construction of the reverse piercing corporate veil system in China. The U.S. courts have gone through a process of relaxing the application conditions of reverse veil piercing from the earlier more stringent standards to some relaxation. However, both federal and state courts have always been very cautious about the application of reverse piercing.

The United States for the reverse piercing of the corporate veil case, the main use of "two elements standard", one is the owner of the company in a particular transaction completely dominate the company, so that the company has become the owner's "alter ego", "tool", "puppet", etc.,. The company and the shareholders of their independent personality no longer exists. Secondly, if the independence of the company's personality is upheld, it will lead to "seriously unfair results" [16]. On this basis, the judge will synthesise the actual situation of the case for value judgement or legal measurement [17]. Judicial practice in the United States shows that when dealing with reverse piercing of the corporate veil cases, a very important value judgement lies in the weighing of interests in the case.

In the 1990 case of *Cascade Energy and Metals Corp. v. Banks* [18], the court rejected a stabbing, primarily on the basis that a stabbing would adversely affect the interests of the company's other shareholders and the company's creditors. Therefore, it is very important to weigh the relationship of the company sought to be pierced with other shareholders and creditors of the company, and the extent to which reverse piercing will have an impact on their interests. Therefore, the point of reference for the construction of a reverse corporate veil piercing system in China is to achieve a delicate balance between the public interest and the interests of specific subjects (other shareholders of the company and/or creditors of the company) that may be harmed in a reverse corporate veil piercing case.

### **4.2 The Construction of China's Reverse Corporate Veil Piercing System**

The United States' case law in dealing with reverse veil piercing cases is in the "two elements standard" based on factual judgement, and through the judge in different cases in the value judgement to achieve the balance of interests of all parties. However, our judges are more accustomed to adjudication based on statutory law, therefore, in the process of constructing the system of reverse veil piercing, it is necessary to clarify the basis for adjudication, the application of standards, uniform adjudication scale, and build a mechanism for coordinating the interests of the relevant, in order to avoid the confusion of the adjudication results, and to achieve the unity of the judicial adjudication.

#### **4.2.1 Improvement of Legislation on Reverse Corporate Veil Piercing System**

China currently only has piercing the corporate veil of the relevant provisions, no direct provisions

of the reverse piercing the corporate veil of the provisions. But the current company law piercing the corporate veil has inherent logical flaws, it can not take up the reverse piercing the corporate veil of the case of the legal application of the heavy responsibility. China's current corporate personality denial system still need to be further resolved by the court in the trial. The paper holds that it should add the new provisions in the Company Law as a reverse piercing the corporate veil of the direct legal basis. However, it is a very difficult task to develop the norms for reverse piercing of the corporate veil, coupled with the fact that there are case-by-case differences in the circumstances applicable in practice, and that uniform and unchanging norms are difficult to address the rich and varied circumstances in practice, the author believes that the improvement of reverse piercing of the corporate veil should also include the continuous revision of the legislation, the release of judicial interpretations, judicial policies and guiding cases.

#### **4.2.2 Clarification of Applicable Standards**

In terms of subject elements, creditors of specific shareholders of a company are the subject of the right of reverse piercing by outsiders, the company requested to pierce the veil is the subject of liability, and specific shareholders abusing the personality of the company's law appear as associated subjects. Outsider reverse piercing is usually applied to both illegal transfer of assets and high degree of personality mixing, with different behavioural manifestations. In terms of the result element, the application of reverse piercing by outsiders should not only examine the damage caused by the abusive behaviour of the connected subject to the interests of the right subject or the public interest of the society, but also take into account the possible loss of interests of the innocent shareholders of the company and the creditors of the company.

#### **4.2.3 Building a Coordination Mechanism for Relevant Interests**

The key issue for the coordination mechanism of relevant interests in reverse piercing cases is how to determine the order in which shareholders' creditors, shareholders of the company and creditors of the company are to be paid through the ranking of interests. The substantive criterion for piercing the corporate veil is the balance of interests. To ensure that the positive effect of the application of the reverse veil piercing rule is greater than the negative effect on the company's bona fide shareholders and third parties, the interests of the company's creditors and other related parties should be co-ordinated, and the order of payment should be the order of the company's creditors, the bona fide shareholders and the shareholders' creditors. Because the company's property should be prioritised to settle the company's debts, and the reverse piercing of the corporate veil is a bottom-up remedy, the shareholders' creditors are the lowest in the pecking order. For the relief of bona fide shareholders, their interests can be protected by setting up the right of capital withdrawal. The creation of a right of first refusal for corporate creditors safeguards the interests of corporate creditors.

## **5. Conclusions**

Due to the lack of enactment norms, reverse piercing of the corporate veil dispute adjudication has brought great challenges to the judges, and the construction of reverse piercing of the corporate veil system is the response of the company law theory to the dilemma that exists in the judicial practice. Reverse piercing the corporate veil is of great significance to make up for the omission of the actual law, to protect the shareholders and creditors, and to maintain the fairness and justice of the market transaction, and its system value is irreplaceable. Reverse piercing the corporate veil should not subvert the corporate personality at the expense of independence, it should focus on balancing the interests of shareholders and creditors and the company and its stakeholders. It should be revise the company law, the development of judicial interpretation for reverse piercing the corporate veil to establish a direct normative basis. It should unify the application of standards and establish the relevant interests of the coordinating mechanism for the realization of the three-dimensional construction, promoting healthy and sustainable development of the company.

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