

Application of the Legal Personality Denial System in Chinese Law in Parent-Subsidiary Companies

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ABSTRACT

The system of denying the personality of the juridical person, also known as "piercing the corporate veil", refers to a legal measure that is set up to prevent the abuse of the independent personality of the company and protect the company's creditors and social public interests. The independent personality of the company and the shareholders behind it and the limited liability of shareholders according to specific facts in specific legal relations are denied to order the shareholders of the company to be directly responsible for the company's creditors or public interests and achieve the goal of fairness and justice. As a highly related parent-subsidiary company, in practice, the parent company often takes advantage of its controlling position to conduct unfair transactions with its subsidiaries, thus infringing on the interests of creditors. This paper mainly uses the method of case analysis, through inductive judgments, it is found that in the trial of related cases of affiliated companies, the proportion of supporting the denial of legal personality is high, the applicable requirements are not uniform, the refereeing basis is confusing, and there is a phenomenon of over-reliance on the denial of legal personality system. There are two reasons behind this. One point is that the abstraction of the current law is high, and the other one is the denial of horizontal legal personality faces the problem that is the lack of judgment basis. This paper argues that it is necessary to study the application of the system of disregard for legal personality in related transactions of parent-subsidiary companies. China should continue to refine its standards and learn from international cases in the future, one possible way is to change from a separate entity model to a single enterprise model.

Keywords: Denial of legal personality, Parent-subsidiary company, Protect the interests of creditors, application of the law.

1. INTRODUCTION

There are different views on whether the system of disregard for corporate personality can be directly applied to affiliated companies. Professor Zhu Ciyun believed that the confusion of related companies' personalities is a form of corporate alienation, which can be corrected through the denial system of legal personality. [1] Another point of view is that it should not be applied. Some scholars represented by Professor Liu Jiangong believe that no matter what analogy or expansion explanation is adopted, the law cannot be used as the legal basis for the case of confusing the personality of affiliated companies. The main reason is that Article 20 of China's Company Law regulates that the main body is the shareholder who abuses rights, and there is no provision for affiliated companies, so it cannot be extended to affiliated companies. [2]

This part will describe the legal basis of related

company's personality denial cases. One view supports taking the third paragraph of Article 20 of the Company Law as the legal basis, among which there are roughly three theoretical bases. The first one is that some scholars represented by Professor Zhu Ciyun interpret the first paragraph of Article 20 of the Company Law, and think that this clause is an all-inclusive provision of the legal principle of corporate personality denial. As long as a shareholder abuses the independent personality and limited liability of the company, the shareholder's liability will be extended to the affiliated companies controlled by the shareholder, so the provisions of this paragraph can cover the applicable legal personality of the affiliated companies.[1] Secondly, Professor Liu Junhai believed that from the perspective of legal interpretation, the third paragraph of Article 20 of the Company Law can be expanded and explained, and the traditional system of denying the personality of legal persons can be extended to the denial of the personality of affiliated companies.[3] Thirdly, Professor Han Qiang

thought that from the perspective of legal doctrine, the confusion of liability and property formed by affiliated companies under the control of controlling shareholders is similar to the core elements of Article 20(3). Therefore, the third paragraph of Article 20 of the Company Law can be applied by analogy to cases of personality confusion in affiliated companies. [4] Another view is that it can't be analogized. The application of the principles of fairness, honesty, and credit of civil law and the provisions of Article 3(1) of the Company Law can solve such disputes, which can be used as the legal basis for the court to deny the independent status of the company. [5]

When discussing the constituent elements of personality denial of affiliated companies, the theoretical circle mainly includes three elements theory and four elements theory. According to the theory of three elements, the applicable elements of the system of denial of corporate personality include the main body, behavior, and result elements, and the main elements advocate that the right subject is the creditor and the obligation subject is the right abuser. On the behavioral elements, the shareholders of the company abuse the independent qualification of the legal person and the limited liability of shareholders. As a result, the interests of creditors are damaged, which cannot be realized or the social interests are damaged.[1] Based on the three requirements, the four requirements theory holds that it is necessary to judge whether the shareholders who abuse their rights have subjective malice.[6] Others think that based on the three requirements, the prerequisite of the company's main body should be added, that is, the company should be legal, effective, and obtain an independent legal personality.[7]

The modern company system is mainly a limited liability system, focusing on the interests of shareholders. However, group companies and parent-subsidiary companies are emerging. Enterprises use the independent legal personality of subsidiaries or affiliated companies to divide business and avoid risks, which leads to cost externalization and damages the interests of creditors. In this case, the court can deny the legal personality (pierce the veil of legal person) to ask the parent company or affiliated company to bear joint and several liabilities.

Denial of corporate personality refers to a legal measure that temporarily denies the independent personality of the company and the shareholders behind it and the limited liability of the shareholders in certain events such as between subsidiaries and parent companies or between shareholders and companies, and orders the shareholders to be directly responsible for the company's creditors or public interests, if the company is still fully admitted to having formal independent personality in this event, which will violate the principle of fairness and justice or infringe on the trading safety of third parties. Obviously, this principle is a revision of the

independent personality of the company and the limited liability of shareholders, and its main function is to correct and remedy the abuse of the limited liability of shareholders and the independent legal person status of the company. [8] Generally speaking, this system originated from British and American precedents. In the judicial practice of various countries, the system of disregard for corporate personality has become increasingly widespread. However, in most countries, the system has not actually risen to the system level officially confirmed by law, but is mainly confirmed and applied by legal principles and cases. At present, only a few countries, such as Britain, France, Italy, and China, have established the denial system of corporate personality through legislation. Article 20(3) of the Company Law of the People's Republic of China is the only statutory law on the denial of a legal personality in China so far. As a general rule, its content was originally abstract, and the applicable conditions and judging standards of people's courts at all levels for the rule of disregard of legal personality have been in urgent need of coordination and unification. In the past 10 years, many courts have made the judgment of denying the personality of legal person under the background of "no legal basis", and the number has increased year by year. However, due to the lack of judgment basis, people's courts at all levels have not yet reached a consensus on the judgment rules of the denial of horizontal legal personality, and judges are faced with confusion in many links from interest measurement to judgment technology, which eventually leads to inconsistent judgment and affects the unity of judicial judgment. Through the general description of case samples and the analysis of typical cases, we can reveal the current trial situation of the denial of legal personality of affiliated companies, and find consensus judgment rules, to improving new legal norms.

Can the forward disregard rule of corporate personality stipulated in Article 20, paragraph 3 of the Company Law be applied to related companies of non-parent companies? In the application of the corporate personality denial system, the responsibility relationship between affiliated company is worthy of attention. Affiliate companies can be divided into two categories in the context of company groups. The one is between the corporate controlling shareholder and its parent-subsidiary company, which is the core type of affiliate companies. Secondly, it is between the subsidiaries controlled by a controlling shareholder and sister companies, which is the derivative type of affiliated companies. In the process of summarizing Chinese judgments, this paper discusses the premise and theoretical disputes of parent-subsidiary companies applying the system of disregard of legal personality, analyzes the court views of judgments, and summarizes the applicable standards of the Chinese system of disregard of legal personality in group companies.

2. THE PREMISE AND THEORETICAL CONTROVERSY OF THE SYSTEM OF DISREGARD OF LEGAL PERSONALITY IN THE APPLICATION OF AFFILIATED COMPANIES

2.1. Precondition

The court must have three elements to deny the corporate personality: firstly, it must prove that the shareholder's abused, the independent legal personality, and the principle of limited liability. The second point is subjective elements, which means abuse is aimed at avoiding debt repayment; Finally, it is the consequence: abuse causes serious damage to the interests of creditors.

The conditions of shareholders' behavior include the confusion of shareholders and the confusion of company personality; Using shareholders' corporate personality to avoid contractual obligations; And especially the lack of capital: in judicial practice, we can't deny the legal person's personality just because shareholders make a false capital contribution or withdraw their capital contribution, which leads to the shareholders' joint and several liabilities. [9]

2.2. Theoretical Disputes

From the perspective of law and economics, the limited liability system has many important functions, but the importance of these functions has weakened in the company group. Specifically, for individual investors, limited liability can reduce three transaction costs. [10] The first one is the cost of individual shareholders supervising management, because even if the company goes bankrupt, shareholders' responsibilities are limited to their contributions to the company. The second cost is that individual shareholders supervise the wealth of other shareholders. Reducing this cost is conducive to the transfer of stocks, which is conducive to the operation of the securities market. Thirdly, limited liability makes the cost of shareholders' diversified investment lower. Without the protection of limited liability, investment diversification will be very dangerous, because if any company in the portfolio goes bankrupt, investors may bear the unlimited liability and suffer disaster.

However, the above economic function of limited liability may be greatly reduced in the case of the company group. First of all, when the ownership of the company is highly dispersed, and the supervision cost is high due to the collective action problem, the function of limited liability to reduce the supervision cost is important. In a company group, some parent companies usually have strong control over the operation of their subsidiaries, so the supervision cost is very low.

Secondly, it is meant to promote the operation of the securities market by reducing the supervision cost of

other shareholders only when the company is listed. In most cases, subsidiaries are highly controlled by their parent companies, and they are not eligible for listing. Therefore, the operation of the securities market has little to do with them.

Finally, the purpose of the parent company's shareholding in the company group is to control and implement the group's business strategy, not for financial investment. Therefore, the decentralization function of equity investment is of little significance.

As limited liability is applicable to all levels of corporate group structure, corporate groups bear limited liability within the scope of limited liability. That is, individuals set up parent companies and parent companies set up subsidiaries, so that individual shareholders enjoy the dual protection of limited liability. This breaks the balance mechanism originally applicable to individual shareholders and creditors, greatly increases the space for individual shareholders to abuse limited liability, and puts creditors' equity and property in a very unfavorable passive position. (This passive position is caused by the abuse of limited liability by individual shareholders.)

Compared with individual shareholders, the court should be more willing to pierce the veil of the company in the background of the company group, because the income of limited liability decreases and the cost increases in the background of the company group. In addition, because involuntary creditors may be more vulnerable to infringement, the court should be more willing to pierce the veil in infringement cases than in contract cases. Some American scholars even suggested that the court should pierce the corporate veil as long as the parent company is found to have over-controlled subsidiaries. [12]

3. ANALYSIS OF CHINESE JUDGMENT

Before analysis, "group company" and "denial of legal personality" are used as keywords, and the case type is "civil case", and about 500 domestic-related judgments are searched. More than 100 copies were randomly sampled and summarized. In this paper, the judgments concerning the denial of the legal personality of affiliated companies are extracted, and the increasing trend is obvious, concentrated in economically developed areas, and the denial rate in economically underdeveloped areas is relatively high. The identity of the plaintiff's individual or company has no significant influence on the denial rate, and the denial rate of infringement cases is not higher than that of contract cases.

Among the denial reasons, the applicable cases with obvious capital shortage are the least, but the denial rate is the highest. Mixing is the most common reason for piercing the veil, but the piercing rate is the lowest.

Various denial reasons are often mentioned and interacted at the same time.

3.1. Defendant Analysis

After reading the judgment book, it is found that the denial rate of the defendant's corporate personality exceeds 60%, but the reasoning of most judgments is too simple.

Regarding the denial rate of different trial times, it is found that the denial rate of the first trial, the second trial, and the retrial shows a decreasing trend, in which the denial rate of the first trial is close to 80%. As the legal level of judges in the second instance is higher than that of judges in the first instance as a whole, they are more cautious in denying the company's personality. [13]

3.2. Judge's Viewpoint

Most judges take "confusion of personality" as the main reason for judging, and there are different expressions in judgments about the constitutive requirements of "confusion of personality". In addition, the reasons for the judgment also include illegal transfer of company property, requiring subsidiaries to provide huge guarantees for themselves, disordered registration of property rights of offices shared by affiliated companies, upstream and downstream relationship of affiliated companies, publicity of belonging to the same group, and active participation of affiliated companies in the contractual relationship between debtors and creditors, etc.

As for the identification and judgment basis of damaging the interests of creditors, in the awards supporting the denial of corporate personality, there are some cases in which the affiliated companies are required to bear joint and several liabilities from the perspective of contract law, which does not involve the identification of "damaging the interests of creditors"; Most judgments mentioned that the defendant's behavior "harmed the interests of creditors".

Therefore, it can be found that harming the interests of creditors is the premise of judgment. Most judges take "personality disorder" as the main reason for judgment, but the judgment basis is not uniform.

The persistence and extensiveness of confusion also need to be considered comprehensively. For example, after the reorganization of the company, the original company has not been canceled, and the business premises, personnel, and assets of the original company and the reorganized company are confused, which constitutes personality confusion. There is a view in judicial practice that the judgment of personality confusion, property confusion, personnel confusion, business confusion, office confusion, and management confusion must be possessed at the same time, and if one

or several elements are not met, the proof is insufficient. The author believes that personality denial is not one of the confusions, and the court should conduct the necessary review and comprehensively judge whether the company has lost its independence as a legal person based on the results of the investigation and evidence collection.

4. THE APPLICABLE STANDARD OF LEGAL PERSONALITY SYSTEM IN AFFILIATED COMPANIES

Although there are no special rules for parent-subsidiary companies, through analysis and judgment, it is found that Chinese courts have three important characteristics when considering relevant deny factors, namely, confusion of personality, significant shortage of capital, and excessive control.

4.1. Confusion of Personality

Personality confusion will be mentioned in most cases, and this factor alone often leads to the denial of corporate personality. Confusion can be subdivided into three types, including property confusion, business confusion, and personnel confusion. Among them, property confusion appears most often, which is roughly the same as the results of some previous studies. [13]

In most judgments, the business confusion in company group cases is far more important than the confusion between property confusion and personnel, which indicates that the court pays more attention to the substantive business transactions within the company group, rather than the formal overlap of property and personnel.

4.2. Significant Shortage of Capital

In recent years, the significant capital shortage has only been mentioned in a few cases, and it is closely related to China's long-term adoption of the legal capital system. The statutory capital system has minimum capital requirements, and the company's capital must be paid within the statutory time limit, which means that if the company abides by the above-mentioned capital system, it is generally regarded as having sufficient capital.

In 2013, China made important reforms to the statutory capital system, including deleting the minimum capital requirement, thus eliminating the disadvantages of judging capital adequacy by the minimum capital requirement, and the court needs to redefine the standard of significant capital shortage.

4.3. Excessive Control

As mentioned earlier, after the chaos of control business, the influence of the over-control problem

increases, but the court faces great difficulties in judging whether there is over-control. Generally speaking, the court requires the parent company to surpass the role of normal shareholders, but the difficulty lies in how to define the role of normal shareholders under the specific background of the company group. If the parent company, as a passive financial investor, doesn't participate in the management of its subsidiaries at all, there will naturally be no excessive control. However, in reality, the parent company usually supervises or coordinates its subsidiaries, and even deals with them to implement the overall strategy of the group and achieve synergy. This paper finds that when the parent company appoints its representative as the director of the subsidiary company, participates in the general decision-making of the subsidiary company, and even holds the business license and company seal of the subsidiary company. The court held that it was normal control, not excessive control.

5. DIRECTIONS AND SUGGESTIONS

At present, China has adopted the separation entity model of company groups to deal with the debt responsibility of parent-subsidiary companies by piercing the veil system, but this model does not fully reflect the actual situation of company groups. In reality, the member companies in the group are often not truly independent entities, but operate under the coordination and control of the parent company. Moreover, compared with developed countries such as the United States, China's veil-piercing laws are still very young, and there is a lack of legislative and judicial experience. Therefore, if developed countries such as the United States can't handle the veil piercing problem, China will only face greater challenges. Therefore, in the context of corporate groups, we should not only rely on the law of piercing the veil to protect creditors, but also think about new ways.

One possible way is to change from a separate entity model to a single enterprise model. Compared with the separated entity model, the single enterprise model may more fully reflect the business reality of the company group. In practice, at least as far as the controlling shareholder is concerned, the company group is usually managed as a single enterprise. Although the member companies in the group operate separately on the surface, they are actually commanded and coordinated by the holding company to realize the overall strategy of the group. However, at this stage, China should not simply change from a separate entity model to a single enterprise model. Under the single enterprise model, all companies in the group may be responsible for the debts of the whole group, which actually gives up the protection of limited liability of the company. From the perspective of functional comparison, the single enterprise model is to pierce the veil of the company completely and automatically. Therefore, it is the rigidity and overuse of

the veil-piercing mechanism, which is not conducive to the development of the company group system. In China, the phenomenon of "enterprise groups" is relatively new. From an economic point of view, corporate group structure has many advantages, including reducing commercial and legal risks. China needs to make use of the organizational form of corporate groups to further make the industry bigger and stronger and more competitive internationally.

6. CONCLUSION

With the development of social and economic life, the abuse of corporate personality and limited liability is constantly being renovated, which also promotes the development of the theory and practice of the system of denying corporate personality. From a global perspective, the system of disregard of corporate personality has already broken through the scope of application of traditional shareholder abuse, showing an expanding application situation, mainly including the reverse application of denial of corporate personality and denial of corporate personality among affiliated companies. Although China's company law introduced the system of denial of legal personality as early as 2005, its scope of application was too narrow, and the reverse application of denial of legal personality and denial of legal personality between affiliated companies were not involved. As a result, in practice, when the debtor company is seriously confused with other affiliated companies and seriously damages the interests of creditors, there is still no clear legal basis for creditors to try to make affiliated companies apply the principle of denial of legal personality. [15]

This paper focuses on the application of the system of disregard for corporate personality in affiliated companies in China, and analyzes the judgment by case analysis. Meanwhile, this paper holds that China should pay attention to how to refine the judgment standard in future research. In the regulation of corporate groups, China should not rely too much on the system of disregard of corporate personality to protect creditors, but should learn from the relevant experience of foreign countries.

Generally, on the premise that the judicial practice of disregard of corporate personality has been relatively rich in our country, the court should adhere to the principle of modesty, and the court can only use the system of disregard of personality on the basis of sufficient evidence and complete constitutive requirements of disregard of personality. Otherwise, the independent personality and limited liability of the company should be adhered.

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