The Logical Framework for Disregard of Corporate Personality of Affiliated Companies

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Abstract: With the integration of the disregard of corporate personality system for affiliated companies into the Company Law in China, it is imperative to provide precise interpretations of the relevant provisions in order to regulate corporate operations and uphold order effectively. Through the examination of pertinent cases and the synthesis of theoretical perspectives in the field, this study delves into the theoretical underpinnings and practical challenges of the disregard of corporate personality system within affiliated companies. Based on this foundation, it is argued that a comprehensive understanding of this system must be approached from three critical aspects: the entity dimension, in litigation scenarios, creditors should act as plaintiffs, the debtor company as the defendant, and affiliated companies as co-defendants or third parties. As for the conduct dimension, apart from formal elements, a crucial focus should be placed on whether the shareholders of the debtor company have engaged in improper benefit transfers through affiliated entities. The intentional impairment of creditors' interests by controlling shareholders is not a mandatory element for disregarding the corporate personality of affiliated companies. Accurate comprehension of these three dimensions is essential to ensure the rational application of this system.

Keywords: Disregard of Corporate Personality of Affiliated Companies; Company Law; Normative Interpretation; Affiliated Shareholders; Benefit Transfer

1. Introduction

The recent revision of Article 23(2) in the Company Law has introduced new provisions pertaining to the disregard of the corporate personality of affiliated companies. To ensure the effective application of the affiliated companies' corporate personality disregard system while mitigating the risk of its misuse, it is imperative to elucidate the logical framework in a systematic and coherent manner.

Through a detailed analysis of Article 23(2) of the Company Law, the normative structure of this provision can be succinctly summarized into three fundamental aspects: the criteria determining involved parties, the essential condition of act, and the prerequisite of result. Additionally, given the existing discrepancies in the interpretation of subjective elements concerning those who may abuse corporate personality, both in the considerations of constitutive requirements and the application of the system, the following discussion will elaborate on this issue comprehensively.

2. The Examination of Subjective Conditions

In determining the eligibility of a debtor company to bring a lawsuit for the disregard of an affiliated company's corporate personality, several crucial considerations must be taken into account: Primarily, as a jurisdiction governed by statutory laws, it is imperative to adhere to a strict interpretation of legal provisions to uphold the logical integrity of the legal framework. Furthermore, within the context of the affiliated company's corporate personality disregard regime, permitting a debtor company to institute legal action would essentially necessitate the company to actively renounce its independent legal status, a notion that poses significant logical challenges. Moreover, a debtor company controlled by shareholders who exploit the company's independent legal personality forfeits its autonomy and is thus unlikely to independently pursue legal recourse. Therefore, the initiation of legal proceedings is typically restricted to creditors or shareholders of the debtor company. Shareholders who manipulate the independent legal personality of the debtor

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company do so to advance their own interests, thereby lacking the incentive to pursue legal action. The potential for other shareholders of the debtor company to serve as plaintiffs in a corporate personality disregard lawsuit merits consideration. Should a court nullify the legal identity of the debtor company, the inclusion of other affiliated companies as joint debtors could lead to a reduction in the company's liabilities, thereby favoring the interests of shareholders and fostering their motivation to seek legal redress. Nevertheless, given that the corporate personality disregard system operates as an exception within the legal entity framework, its application is contingent upon the exhaustion of all alternative remedies. For other shareholders, recourse through directly suing shareholders who abuse their rights, as outlined in Article 21(2) of the Company Law, suffices for obtaining relief. Consequently, it is reasonable to assert that shareholders of the debtor company are generally ineligible to pursue a corporate personality disregard lawsuit.

Once the court supports the creditor's claim in the lawsuit for the disregard of the affiliated company's corporate personality, the affiliated companies with a relationship to the debtor company will bear joint liabilities. In this scenario, what position do the affiliated companies hold in the lawsuit for the disregard of corporate personality? According to the provisions of the 9th Conference Minutes, in a vertical disregard lawsuit initiated by the creditor after the debt claimed against the debtor company has been confirmed by a final judgment, the shareholders are defendants, and the debtor company is a third party. Although the 9th Conference Minutes touch on aspects of horizontal disregard, it does not explicitly outline the status of the parties involved in horizontal disregard. In past judicial practices, when a creditor initiates a horizontal disregard lawsuit, the debtor company and affiliated companies are typically named as co-defendants. [1]The question of whether affiliated companies can proactively file a lawsuit for the disregard of corporate personality in relation to the debtor company needs to be analyzed based on different circumstances. When an affiliated company initiates a lawsuit to deny the debtor company's legal personality, thereby assuming joint liabilities with the debtor company towards the creditor, this may appear to be within the realm of private rights disposal and should theoretically be permitted. However, upon closer examination, discrepancies become apparent. The disregard of corporate personality serves as a remedy for the creditors of the debtor company, allowing them to bring legal action when the rightful claims against the debtor company are hindered by the unauthorized actions of those abusing corporate legal identity. This condition contradicts the principles of fairness. In instances where an affiliated company seeks to deny the corporate personality of another affiliated company in order to distribute joint liabilities among related entities, according to the civil litigation subject theory, the affiliated company lacks the corresponding rights to claim and does not qualify as a legitimate plaintiff. Therefore, in legal proceedings, the affiliated company can only assume the position of a defendant or a third party. In cases where the plaintiff fails to nominate other affiliated companies as co-defendants, these entities should be regarded as third parties without independent claim rights.

3. The Constituents of the Behavioral Elements

3.1 Formal Elements

In academic circles, acts of Personality confusion, business confusion, property confusion are universally acknowledged as primary reasons for invoking the disregard of corporate personality. [2]Upon reviewing existing cases in China regarding the disregard of corporate personality for affiliated companies, it becomes evident that courts typically cite "confusion of corporate personalities" as the rationale for the disregard. However, the precise definition of "confusion of corporate personalities" often lacks substantive argumentation in judicial documents. This phenomenon arises due to a lack of clear and unified standards for defining "confusion of personalities" within the court system. The 9th Conference Minutes identifies asset confusion among affiliated companies as the fundamental basis for determining a confusion of personalities, while manifestations such as business confusion, personnel overlap, and address conflation serve as supplementary indicators of this

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confusion. According to the stipulations of Article 3 of the Company Law, the most crucial condition for a company to possess independent personality is to have its distinct assets. Hence, if a company's assets are not able to flow in accordance with its independent will but are arbitrarily controlled by shareholders, then the company loses the foundation for its independent existence. Given that affiliated companies often fall under the dominance and control of the same shareholder, instances of financial exchanges between companies are prone to occur. Therefore, utilizing asset confusion as a criterion for determination aligns with the principles of the corporate system.

3.2 Substantive Elements

The commercial environment is inherently dynamic, prompting profit-driven individuals to devise diverse strategies to evade the circumstances outlined, engaging in other forms of exploitative behaviors in pursuit of maximized gains. Consequently, the exhaustive enumeration of abusive behaviors proves unattainable, as opportunistic entities leverage alternative avenues to elude accountability.

Empirical analyses underscore that while nations vary in their leniency regarding the disregard of corporate legal personality, fraudulence and improper control serve as universally acknowledged substantive grounds for such disregard. [3]Upon deeper examination, it becomes apparent that the crux of shareholder abuse concerning corporate independent personality and limited liability fundamentally hinges on the misappropriation of shareholder entitlements. [4]Unless stipulated otherwise within the company's charter, shareholder duties typically extend to adhering to prescribed capital contributions and maintaining financial integrity, without necessitating direct involvement in company affairs or the obligatory exercise of control through shareholder deliberations. The absence of direct individual dominion over the company endows shareholders with the privilege to leverage the corporate structure's autonomy and limited liability as a mechanism to decentralize operational risks. Yet, the misuse of shareholder prerogatives jeopardizes the foundational principles underlying these entitlements, inevitably resulting in the forfeiture of risk mitigation privileges.

In the context of affiliated companies, shareholders often invest in various companies with the aim of facilitating seamless collaboration, maintaining long-term stable trade relations, and further reducing transaction costs. Within this operational framework, the normal interactions between shareholders and companies should be acknowledged as a natural state, rather than hastily construed as an inappropriate exploitation of corporate personality.[5] However, a pertinent issue that deserves attention in such a scenario is the observation that the role played by the limited liability system within affiliated companies may be less pronounced compared to its function within individual entities. The primary objective for shareholders in establishing a company typically revolves around diversifying investment risks and minimizing supervisory obligations. Yet, in the aforementioned investment and operational model, the purpose of shareholders diversifying investments shifts from risk mitigation to promoting transactions between the holding companies. Consequently, the efficacy of the limited liability system in facilitating investments is diminished; the existence of a natural state of interaction between shareholders and companies allows shareholders to have intimate knowledge of the company's operations, potentially leading to a neglect in overseeing directors and managers due to the oversimplified perception of limited liability. Limited liability ceases to serve as a safety net for investors but rather introduces moral hazards for shareholders holding stakes in affiliated companies, offering a tool for unscrupulous individuals to exploit control over multiple companies under the guise of corporate personality, profiting unfairly. The unlawful nature of such abuse lies in the improper funneling of benefits through affiliated companies, resulting in harm to creditors and contravening the equitable values underpinning the corporate system. Therefore, when assessing the grounds for the disregard of corporate personality within affiliated companies, it is imperative to consider the misuse of rights by shareholders for improper benefit transfer as a fundamental criterion. Factors to be considered include the

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confusion of assets, personnel, operations, and addresses within the affiliated companies. [6]

4. Consequential Elements

As stipulated in the Company Law, when considering the disregard of corporate personality within affiliated companies, the crucial factor lies in the substantial harm inflicted upon creditors' interests due to the confusion of these associated companies. Thus, the core of this requirement hinges on the measurement standard regarding the severe harm endured by creditors' interests. [7]Divergent viewpoints exist regarding this assessment metric: some posit that when a debtor lacks the assets to satisfy creditors' claims, it signifies severe harm to creditors' interests; [8]others argue that the benchmark should revolve around the company's insolvency. Adhering to the principle of prioritizing substance over form, utilizing the company's insolvency as the benchmark for the prerequisite of the result is deemed more fitting. [9] On one side of the spectrum, a surplus of assets over liabilities on a company's balance sheet does not automatically guarantee complete creditor reimbursement. On the other side, the disregard of corporate personality in affiliated companies culminates in these entities assuming supplementary responsibilities for each other's specific debts, which are primarily financial obligations rather than personal liabilities. Thus, fundamentally, this process entails the reciprocal bolstering of solvency among affiliated companies. Such an analytical framework aligns harmoniously with the doctrine of enterprise unity and facilitates the coherence of legal system rationale.

5. Subjective Elements

Whether the intention of a controlling shareholder in abusing a company's independent personality is to harm creditors' interests constitutes a necessary element of the system for disregard of corporate personality in affiliated companies, it remains a point of contention with proponents and opponents alike. Ultimately, the evaluation should revert to an examination of the system itself.

Primarily, the fundamental objective of this system is to uphold the company's independent personality. Therefore, when assessing shareholder conduct, the focus should center on whether the integrity of the company's personality has been compromised. The primary aim of a shareholder abusing the company's independent personality is typically to maximize personal gain, rather than specifically intending to harm creditors' interests.

Furthermore, the nature of this system serves as a post-facto remedial measure to rectify imbalances between a company and its creditors, as opposed to punitive action against those abusing corporate personality. Shareholders have violated the contract of limited liability by relinquishing control rights over the company in exchange for limited liability. Hence, shareholders no longer receive the consideration of the contract – limited liability – leading to the legal consequence of shareholders assuming joint liability with debtors, characterizing their responsibility as a breach of contract. The principle of liability attribution under breach of contract typically follows a principle of strict liability, rendering the intentional harm or lack thereof to creditors' interests inconsequential in determining the shareholder's accountability.

6. Conclusion

The independent personality of a company and the limited liability of shareholders stand as the cornerstone of company law. The system of disregard of corporate personality in affiliated companies aims to achieve fairness and serves as a means to breach the independent personality of a company and the limited liability of shareholders under specific circumstances. Therefore, when applying this system, a cautious understanding of its applicability must be approached from the perspective of normative construction. One should not refrain from application due to the high level of abstraction in norms, nor should one apply it arbitrarily due to the principled nature of norms. Only by comprehensively grasping the subjective elements, behavioral elements, and consequential elements can this system be effectively utilized to fulfill its intended purpose.

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