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On the Development of the Doctrine of Legal Personality Denial in the Insolvency of Associated Enterprises

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Abstract

With the increasing number of bankruptcy cases, the insolvency of associated enterprises among them has gradually attracted widespread attention. The theory of legal personality denial has entered the field of bankruptcy law from corporate law and other fields, and is mainly applied to solve the problem of bankruptcy of associated enterprises, but the legal personality denial system has greater limitations in the current judicial application in China. Through the examination of extraterritorial application, in the new Enterprise Bankruptcy Law in the future, a special chapter on the bankruptcy of associated enterprises should be established. The denial of legal personality system should be the core, mainly dealing with the abuse of legal personality and supplemented by the two major principles of substantive consolidation and equitable subordination and applied prudently. In the process, it will be continuously integrated with China's judicial practice. The changes in the status of the three institutional principles will be considered when the legal system for the bankruptcy of associated enterprises is perfect and mature.

Keywords: associated enterprises, denial of legal personality, substantive consolidation, equitable subordination

1. Overview

1.1 The Doctrine of Denial of Legal Personality

On what is "legal personality denial", within the academic community is usually the mainstream view of Professor Zhu Cixiang's definition, that is, "when the independent personality of the company and shareholders limited liability is abused, based on the interests of creditors, public interest protection and fairness, justice objectives to achieve the consideration, can be in a specific In the legal relationship between the company and its shareholders as a unified whole, so that the shareholders behind the external liability (Zhu Ci Yun, 1998)." The essence of this definition can be summarised as three points: the objective of application is to maintain the core values of justice and fairness, the specific way of application is to deny the independent legal personality of the company in a specific legal relationship and the result of the application is to pursue the legal responsibility of personality abuse (Nan Zhenxing & Guo Dengke, 1997).

The doctrine of legal personality denial has an important place in judicial practice, not only in corporate law, contract law, tort liability law and other branches of law, but also in insolvency law as judicial activity in insolvency cases has increased in practice. The introduction of the doctrine of denial of personality into insolvency law has led to a growing number of studies combining the two. Separately, the former places greater emphasis on the goal of social justice values, often achieved by safeguarding the company's creditors and the public interest, while the latter tends to achieve the goal of economic efficiency under the premise of maintaining fairness and reducing the cost of realising claims through various measures (Geng Yuanhong, 2019). The significance of the combination of the two is thus becoming clearer, namely to better protect the interests of

creditors and balance equity and efficiency. By applying the doctrine in insolvency proceedings, creditors can claim supplementary liability from natural shareholders or other affiliated companies, which is a good way to realise their claims and does not undermine the theoretical basis of company law. In the process of combining the two studies, the issue of associated enterprise insolvency is more relevant and closely related to this theory.

1.2 Issues Relating to the Insolvency of Associated Enterprises

There are two broad and narrow concepts of affiliated enterprises, but this article is based on the broad concept of affiliated enterprises. An associated enterprise is essentially an association of companies, including but not limited to control companies, subsidiary companies, parent companies, subsidiaries and sister companies, each of which has a separate legal status and has the ability to exert significant influence or is controlled by the same enterprise due to an equity, contractual or other relationship between them (Sun Xiangqi, 2008). However, this definition is not directly provided for in the Company Law or the Bankruptcy Law, but was first established directly in the Implementing Regulations of the Tax Collection and Administration Law. [1]Some of the characteristics of an associated enterprise can be summarised from the above, namely that each enterprise has a separate personality, that there may be a clear relationship of control and control between the enterprises, that independence is often affected by the relationship and that there is a tendency to transfer economic interests (Zhong Danping, 2018).

As a result, a particular issue often arises in the insolvency of associated enterprises: the protection of creditors' interests. This gives rise to many new problems, such as the complex control relationships within the associated enterprises often provide a barrier to the transfer of assets, concealment of property, fraudulent bankruptcy and other improper acts, which directly affects whether creditors' claims can be satisfied; furthermore, the existence of associated debts, mutual guarantees and other phenomena, the existence of shell companies and offshore companies, which make the flow of funds and liquidation of assets more troublesome and thus indirectly affect creditors. These make the liquidity of the enterprise and the liquidation of its assets more troublesome, thus indirectly affecting the efficiency of creditors' claims (Wang Xinxin & Cai Wenbin, 2008). The three most prominent manifestations are the blurring of the independent will of the enterprise, the threat to the independence of the enterprise's property and the interference with the independence of the enterprise's liability capacity, the direct consequences of which are, first and foremost, the impact on the legal person system, which in turn undermines the legitimate rights and interests of creditors (Sun Xiangqi, 2008). Therefore, it is necessary and meaningful to study the specific application of the doctrine of denial of legal personality only from the perspective of protecting the interests of external creditors.

The doctrine of denial of legal personality has a wide scope of application and is mainly regulated by the company law, as reflected in Article 20[2] , which is established by statute. From the interpretation of the text, the company law provides for the denial of legal personality in a relatively small number of situations, covering only between shareholders and the company, but its theoretical application is diverse, including the application between associated enterprises. To summarise the application of this theory in the insolvency of associated enterprises can be divided into four types of situations: one is in the appointment of personnel, work affairs, capital and property are highly mixed, this is a more common situation in the associated enterprises; two is because there is excessive control to the detriment of independent personality; three is a significant shortage of capital, and therefore can not meet the normal operating needs of the company; four is fraud and other improper behavior, such as the establishment of shell companies, transfer of assets to avoid debt. Fourth, fraud and other improper practices, such as setting up shell companies, transferring assets to avoid debts, etc (Zhong Danping, 2018). The academic community agrees that if there is evidence of the above four situations, the legal personality of the lawsuit can be filed and claim the application of the theory of legal personality denial. There are exceptions to the general rules of application, such as the protection of their own interests; because the previous illegal acts may cause losses and set up a new company; because the protection of individual denial only in the trial stage of the application does not extend to other procedures, etc. can not claim the denial of legal personality (Sun Xiangqi, 2008).

In the case of the insolvency of associated enterprises, the immediate manifestation of the application of the doctrine of denial of legal personality is the system of denial of legal personality, but the simple application of this system does not completely resolve the problems that arise in the insolvency process (Sun Xiangqi & Yang Jifeng, 2009). As a result, other regimes have emerged in the application of this doctrine to the insolvency of associated enterprises. In this regard, the denial of legal personality regime and, by extension, the principles of substantive consolidation and equitable subordination, will be discussed and reviewed separately.

2. Legal personality Denial System

2.1 Extraterritorial Application Visits

In other countries, such as the common law and civil law systems, corporate personality denial is also known as

"lifting the corporate veil" and "direct liability", which first appeared in US case law and became the main method for courts to deal with relevant cases, and was later widely used. Although US courts have a wide discretion, judges tend to take a cautious, conditional approach to deciding relevant cases on a case-by-case basis. Thus, before deciding to lift the veil, the judge will often consider whether there has been a failure to comply with the procedural requirements of the company, whether the company is significantly undercapitalised, whether the parent subsidiary is too close in terms of personnel, assets, finances and operations, and so on (Yang Jinrong, 2013). In terms of specific application, the United States applies the regime primarily to creditor protection, based on which theories such as the "agency theory", the "instrumentality theory" and the "alter ego theory" have been developed. Similarly, in Germany, legislation has been passed to classify specific types of associated enterprises, to regulate connected transactions and to clarify the application of the regime in the case of de facto associated enterprises where no corresponding compensation has been given (Zhu Yujie & Wang Yaxin, 2014). In France, where the use of this regime in insolvency law is more detailed, the text lists situations such as "participation in the management of affairs without exercising reasonable care, commingling of assets or mishandling of property, or mixing of businesses", which can directly result in the controlling company being liable for the debts of the subsidiary company in insolvency (Wang Xinxin & Zhou Wei, 2011).

2.2 Application in Associated Enterprises

The unique role played by the legal personality denial system in areas such as corporate law is evident to all, and its introduction into the bankruptcy law used to solve the problem of associated enterprise bankruptcy has a deep jurisprudential value basis, in line with the legislative spirit of bankruptcy law to achieve fairness. The first is reflected in the fact that insolvency itself challenges the independence of legal personality and shareholders' limited liability, and that the interests of the insolvent subsidiary and its creditors are severely damaged by the controlling company's use of shareholders' limited liability as a "shield" in a situation where independent personality is difficult to guarantee. They need to be redefined and not simply applied. Secondly, there is a lack of insolvency legislation, which relies mostly on company law when dealing with insolvency issues and tends to lag behind with new issues arising in judicial practice. Thirdly, the scope of the two existing regimes - avoidance and nullity - is too small to meet the need to combat the improper practices that are constantly emerging in practice. Lastly, the existence of connected claims by affiliated enterprises, which are not provided for in the current legislation, often gives priority to connected creditors over other external creditors (Feng Ka, 2012). In summary, the above four aspects well illustrate the need for the application of the regime in the field of insolvency of associated enterprises.

However, China's bankruptcy law does not provide for the application of the system to general enterprises and affiliated enterprises respectively, but only for the protection of property and the responsibilities of directors and supervisors, and the judicial interpretation of the Supreme Court only provides for certain issues of affiliated enterprises in principle, leaving many legislative gaps. From the existing legal texts, it can be seen that the application of the regime is limited to the protection of the interests of creditors only, and the conditions for its application are stringent (Zhu Yujie & Wang Yaxin, 2014). In addition, the regime is often applied only in individual cases and requires that the requirements of mixed personality and serious prejudice to the interests of creditors are met, which makes it an ex post facto measure that does not solve the general problem of the insolvency of associated enterprises (Sun Xiangqi, 2008).

Due to the above limitations of the legal personality denial system, the principle of substantive consolidation has been widely studied and applied. The relationship between the system of denial of legal personality and the principle of substantive consolidation is controversial in academic circles. Some scholars believe that there are differences in the fields of application, purposes and consequences between the two, and that the principle of substantive consolidation should not be an extension of the legal personality denial system (Wang Xinxin & Zhou Wei, 2011). However, the author believes that the ultimate purpose of both is to pursue a substantive fairness, from the correction of the abuse of legal personality can better protect the legitimate rights and interests of the company's creditors, in general, are around the issue of corporate personality denial. Therefore, the author believes that the principle of substantive consolidation is a special application of the theory of denial of legal personality in the bankruptcy of associated enterprises.

3. Principle of Substantive Consolidation

3.1 An Examination of Extraterritorial Legislation

The principle of substantive consolidation was also created in the United States as a more equitable remedy based on the equitable powers of the United States Bankruptcy Code, and gradually this principle was established through a long series of procedures and cases in the United States. To this day, its concept is interpreted by the academic community from the definition of associated enterprise consolidation bankruptcy, more in the procedural consolidation, that is, in determining the bankruptcy estate, the total assets and liabilities of the associated bankruptcy enterprises are first consolidated, excluding the amount of claims and debts due to

the existence of claims or security relationships between them, after which the consolidated property is uniformly paid to external creditors in the order and proportion of satisfaction (Wang Xinxin & Zhou Wei, 2011).

The US courts initially applied the doctrine on a case-by-case basis to deal with insolvency claims when the controlling company was insolvent at the same time as the subsidiary company. In applying it, there are fewer bases for the court to consider than in a corporate personality denial regime, and there are two main ones. One is the creditor's expectation that it knew of the connection, or even that it entered into the transaction because of the existence of a guarantee of connection, and these require active proof by the creditor. The other is the commingling of accounts and assets, which is generally considered to be the decisive factor in applying the principle.

3.2 The Inevitability of Introducing Application

Before discussing the application of the principle of substantive consolidation to the insolvency of associated enterprises, it is important to mention the implications of separate insolvency of associated enterprises. From both theoretical and practical perspectives, the adverse effects of separate insolvency and consolidated insolvency are that they may result in an imbalance in the payment of different creditors, thereby undermining the fair value of insolvency law (Zhang Shao Li, 2014). Therefore, it is necessary to consolidate bankruptcy.

Although there are no clear legal provisions on the principle of substantive consolidation, there are many cases of substantive consolidation for bankruptcy liquidation and reorganisation in judicial practice, thus its feasibility, reasonableness and value are confirmed by judicial practice (Zhong Danping, 2018). However, the scope of its application is controversial, mainly divided into two opposite views, one is that it should be universally applied, while the other believes that it should be applied on a case-by-case basis and with caution. The reason for this is that there is a gap in the law on associated enterprises in China, and there is no doubt that if the principle is applied universally, it will take into account the two conflicting values of fairness and efficiency in jurisprudence, such as ensuring fairness in most cases, and reducing judicial costs and improving efficiency; in addition, it is also to reduce the occurrence of mixed assets and unclear accounts and to protect the interests of creditors. The interests of creditors (Wang Xinxin & Cai Wenbin, 2008). The scholars, represented by Professor Zhu Cixiang, believe that the principle cannot be applied universally because of the following considerations, firstly, most countries in the world have adopted the exceptions to the application of the principle and remain cautious in applying it (Zhang Shao Li, 2014). Secondly, the principle of substantive consolidation is a denial of the separate personality of legal persons, and its universal application would be detrimental to the interests of some creditors (Yu Lin, 2016). Finally, there is the cautionary approach reflected in the trend of our legislation, such as Article 32 of the Minutes of Bankruptcy Trials, which refers to the possibility of exceptions to substantive consolidation for hearings[3] .

Based on the above two views, the author is more inclined to the latter, that is, the principle of substantive consolidation should be applied cautiously. It is not absolutely correct to take into account the majority at the expense of the minority, and it is therefore prudent to wait until the institutional system is more complete and the rule of law environment is more mature before considering its universal application.

4. The Principle of Equilibrium Resides Here

4.1 An Examination of Extraterritorial Legislation

The principle of deep stone, the principle of equitable control, the principle of subordinate claims are all another expression of the principle of equitable subordination called, which arose in the United States jurisprudence, is a kind of claim settlement subordination of the treatment rules, the judgment is based on whether shareholders have unfair behavior, mainly applied in the context of control, subordinate companies, when the latter after the bankruptcy of the control company's claims in the bankruptcy proceedings to obtain the satisfaction of the problem (Sun Xiangqi, 2008). Prior to this principle, the US courts had been dealing with the issue through the principle of lifting the corporate veil, but the disadvantages of this approach in judicial practice gradually emerged, if we say that the complete denial of the claims of the controlling company, it is for the subsequent reorganisation of the subsidiary company, investment and redevelopment are detrimental, so this principle is in the courts continue to seek a balance of fairness and efficiency created in the exploration (Zhu Ci Yun, 1998).

It can be said that the text of the doctrine of equitable subordination can be found in the US bankruptcy law. The court will then decide on equitable subordination or complete denial of personality (Zhu Ci Yun, 1998). If equitable subordination is to apply, the controlling company's claims against the subsidiary company cannot participate in the distribution together with other creditors or in a subordinate order to other creditors (Sun Xiangqi, 2008).

4.2 The Inevitability of Introducing Application

The principle of equitable subordination is undoubtedly a subordinate claim, which is in line with the system of

denial of legal personality, and is another extension of the doctrine of denial of legal personality in the insolvency of associated enterprises. As mentioned earlier, the principle has the premise of application, i.e. it is limited to the specific circumstances in which the claim exists. Although this scope of application is small, it avoids the denial of personality, and by adjusting the subordination of the settlement, it relatively moderates the damage to the interests of the debtor, and is a milder equitable remedy than the principle of substantive consolidation (Wang Xinxin & Cai Wenbin, 2008).

The reason why this principle is considered to be another innovative development of the theory of legal personality denial is that, like the two systems mentioned above, it is also intended to break through the boundary of "corporate independence and limited liability of shareholders", for the following reasons: (1) the legal personality denial system ignores the existence of some improper acts of the controlling company, such as; (2) The legal personality denial system treats the controlling company and the subordinate company as a unified body, and directly denies the legal personality, which means that it does not support the claims of the controlling company, which will not only harm the interests of the controlling company, but also does not help the subordinate company; (3) the creditor in the application of the legal personality denial system is required to bear the burden of proof, but because this type of evidence often has a high degree of concealment, complexity, the difficulty of proof in practice is higher, thus, through the principle of equitable subordination to open up a new way of relief, to better protect their interests and increase efficiency and reduce costs (Sun Xiangqi, 2008).

In summary, the introduction of the principle is based on the limitations of the legal personality denial system and the impact of the principle of substantive consolidation, whicih is an innovative extension of the theory of legal personality denial development. The introduction of this principle has a great significance for the solution of some practical problems in China, such as one of the most common problems of controlling the right to claim the claims granted by the law of the company and obtaining the assets of the subordinate company in a grand manner, to the detriment of other creditors and shareholders (Sun Xiangqi, 2008).

5. Summary

At present, there are more and more cases involving the bankruptcy of associated enterprises in China's judicial practice, and the above three systems have been applied in bankruptcy proceedings, but there is a gap in China's legislation in this regard, and the basis and results of its decisions lack legitimacy and authority. As a result, more and more scholars are calling for a chapter in the company law or bankruptcy law on the regulation of affiliated enterprises and bankruptcy, in particular, to build a system of regulation on the abuse of affiliated relationships, which consists of three elements: the system of denial of personality, the principle of substantive consolidation and the principle of equitable subordination (Sun Xiangqi & Yang Jifeng, 2009). The above has already mentioned the extraterritorial study of the three principles, the perfect and systematic theoretical system of extraterritoriality has brought many worthwhile experiences to our legislation. In terms of the improvement of the legal personality denial system, it is necessary to clarify the conditions of application, such as establishing the subjective elements that include the party who abuses its personality and the person whose rights are damaged as a result, specifying the conduct elements in the form of a combination of enumeration and generalization, and stipulating the result elements that constitute actual damage (Wang Xinxin & Cai Wenbin, 2008). In terms of the principle of substantive consolidation, the first is the introduction of legislation, although the minutes of the bankruptcy conference have been further specified to the application, such as appropriate restrictions in terms of time and object, the adoption of the German court practice of reversing the burden of proof, the specific process of consolidation of cases in bankruptcy proceedings, the competent court, etc (Zhong Danping, 2018). From the perspective of the introduction of the principle of equitable subordination, it is necessary to take into account both the substantive and procedural normative construction of both aspects, such as expanding the scope of the subject of regulation, identifying clear types of unfair conduct and the losses suffered as a result, the rule of reversal of the burden of proof and the assistance of the hierarchical jurisdiction system, etc. to introduce this principle into the existing legal framework of China (Li Liping, 2017).

In the light of the increasing complexity of associated enterprise insolvency issues, the first application of the doctrine of legal personality denial in insolvency law - the legal personality regime - has shown to be inadequate in solving the relevant practical problems. The value of fairness and efficiency in bankruptcy law has also driven innovation in the theory of denial of legal personality, and the mature theoretical research and legal system in foreign countries has attracted scholars to turn their attention to foreign countries, and the principles of substantive consolidation and equitable subordination have become the focus of attention. In recent years, scholars have focused their attention on how to localise these two principles in the context of China's current situation, so as to enhance the efficiency of the protection of creditors' interests and the orderliness of insolvency proceedings.

The doctrine of denial of legal personality is widely applicable and plays an important role in bankruptcy law. From the perspective of protection of creditors' interests, the first stage of development of the doctrine of denial

of legal personality in the bankruptcy of affiliated enterprises is manifested in the system of denial of legal personality, which can effectively curb the phenomenon of controlling companies applying limited liability of shareholders to evade debts, and will also make up for the inadequacy of bankruptcy avoidance and invalidity system regulation, etc. However, its obvious limitations also cannot meet the new problems in bankruptcy practice. This led to another development of the theory of denial of legal personality, extending the principle of substantive consolidation, specifically to solve the problems of bankruptcy, more targeted than the former, and make claims to obtain a fair settlement, in the application of what attitude it should take once triggered a major controversy in the academic community, in the current view, prudent application of the mainstream trend, which also decided that the principle can only be auxiliary to the denial of legal personality system, in its application In the process of its application, the limitations of its scope and the lack of rigidity have accelerated the emergence of the principle of equitable subordination. The principle is in line with the denial of legal personality system, and belongs to the same theory of denial of legal personality, mainly to solve the problem of the control company in the subordinate company claims settlement, more moderate than the principle of substantive consolidation, so in recent years the proposal to introduce our legislation has been increasing.

Based on the above, the three developments of the theory of legal personality denial have their own focus, and should be considered comprehensively in the legislation, and all three should be introduced into the legal framework of the bankruptcy of associated enterprises, of which the legal personality denial system should be the core, mainly dealing with the abuse of legal personality, which has relevant provisions in the company law and has been used in judicial practice; supplemented by the two principles of substantive consolidation and equitable subordination. applied prudently, in the process, continuously fused with China's judicial practice, for localised development, and then consider the change in the status of the three institutional principles when the legal system for the bankruptcy of associated enterprises is perfect and mature.

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[1] Article 51 of the Rules for the Implementation of the Tax Levy and Administration Law of the People's Republic of China: "Affiliated enterprises referred to in Article 36 of the Tax Levy and Administration Law refer to companies, enterprises and other economic organizations that have one of the following relationships: (a) Direct or indirect ownership or control relationship in terms of capital, operation, purchase and sale; (b) Directly or indirectly owned or controlled by the same third party; (c) other relationships in which interests are linked."

[2] Article 20 of the Company Law of the People's Republic of China: "The shareholders of a company shall abide by the laws, administrative regulations and the articles of association of the company, exercise the rights of shareholders in accordance with the law, and shall not abuse the rights of shareholders to the detriment of the company or other shareholders; they shall not abuse the independent status of the company as a legal person and the limited liability of shareholders to the detriment of the company's creditors. The company shareholders abuse the shareholders' rights to the company or other shareholders caused losses, shall bear the compensation responsibility according to law. Where a shareholder of the company abuses the independent status of the company as a legal person and the limited liability of the shareholders to evade debts and seriously damage the interests of the creditors of the company, he shall be jointly and severally liable for the debts of the company."

[3] Article 32 of the Minutes of the National Conference on Bankruptcy Trials of Courts: "Prudent Application of Substantially Combined Bankruptcy of Affiliated Enterprises. When adjudicating enterprise bankruptcy cases, the people's courts shall respect the independence of the corporate personality of the enterprises and apply the basic principle of judging the causes of bankruptcy of the members of the associated enterprises separately and applying individual bankruptcy procedures. When there is a high degree of conflation of legal personality among the members of the associated enterprises, and the cost of distinguishing the property of the members of each associated enterprise is too high and seriously impairs the interests of creditors in fair liquidation, an exception may be made to apply the substantive consolidation of the associated enterprises in bankruptcy."