World Applied Sciences Journal 28 (1): 98-102, 2013
ISSN 1818-4952

DOI: 10.5829/idosi.wasj.2013.28.01.13781

"Piercing the Corporate Veil" Through the Mechanism of Bringing to the Subsidiary Responsibility in Russia and Abroad

Alexey Aleksandrovich Klyachin and Tatyana Anatolyevna Spirina

Perm State National Research University, Perm, Russia

Abstract: In the article, the variants of Russian and foreign application of "piercing the corporate veil" principle are given and a conclusion is made that the Russian Federation needs a more detailed development of the legal norms associated with flinching from the principle of the legal person participant's liability limitation. The authors performed a comparative analysis of the legislation in the USA, England and Russia, which resulted in the conclusion that in modern conditions of the civil turnover complication, a trend is traced of a more often getting under the "corporate veil" for the purpose of avoiding the abuse of the right. The conclusion is made that it is necessary to adapt the mentioned concept to the actual reality in the Russian Federation, so that the guilty could be more efficiently brought to subsidiary liability and the creditors could have a possibility to satisfy their claims with no unreasonable interference into the legal person independence principle. The proposals on improving the "corporate veil pierce" concept application in the Russian Federation include the legislative fixing of the concept application margins, as well as issuing the orders by the supreme bodies that list the circumstances subject to proving through the just distribution of the burden of proving between the parties.

Key words: Corporate veil · Piercing the corporate veil · Legal persons · Subsidiary liability · Liability limitation · Legal person establishers · Share holders · Making bankrupt · A parent company · Affiliated company · Corporate control · Abuse of right.

INTRODUCTION

It is more and more often that phrase "legal person construction abuse" is met in the official documents of the international organizations, in the reports of the official representatives of the foreign countries, in the Russian and foreign literature on the illegal actions of the legal persons. We mean that due to the imperfection of the legislation requirements, the dishonest persons can use the legal person construction for reaching their illegal goals [1, 2], for example for taking the assets out of the company on the threshold of bankruptcy.

In this case, it is necessary to pierce the so-called "corporate veil" and this is an exception from the principle of the legal person establishers' limited liability.

The name of the doctrine is associated with Maurice Wormser who published his article «Piercing the Veil of Corporate Entity» in Columbia Law Review in 1912. The author spoke up for "piercing the corporate veil" only in cases when the corporation is the "alter ego" of its shareholders, i.e. the corporation is the continuation of their personality and is created for meeting their personal interests, including illegal actions that exclude personal liability [3].

In Russia, the doctrine of "piercing the corporate veil" started to be widely discussed in connection with the global economic crisis [4] and consequently – with the reforming of the civil legislation, in particular – the reforming of Article 56 of the Russian Federation Civil Code (hereinafter referred as the RF CC) [5]. An important role also belonged to the famous regulation of the Supreme Arbitration Court presidium for Latvian bank "Parex" where this doctrine was directly mentioned by the court for the first time [6].

However, as the mentioned doctrine has an insignificant period of development in the Russian reality, it does not have a proper description in the legislation and is not actively used in the law application practice. For

Corresponding Author: Klyachin, Perm State National Research University, Bukireva st. 15, 614990, Perm, Russia.

this reason, it is wise to view this legal institution as shown through the existing foreign regulation that the Russian legislator should be guided by.

The conditions used for "piercing the veil" are formulated in different jurisdictions differently.

Reasons for "Piercing the Corporate Veil" by the Courts of the USA: In the USA, the following factors can be used in total by the courts for stating the fact of "dominating" [7-9]:

- The formal corporate procedures are followed.
- The corporation possesses a sufficient capital.
- The corporate finances are used for personal purposes.
- In case of two companies, the intercrossing in owners, directors and employees is met.
- The two companies use the same office, address, telephone numbers.
- The level of independent finance discretion showed by the controllable corporation.
- The deals with the controllable corporations are made using the "long arm" principles (i.e. using the same conditions as those used for independent contractors).
- The corporation is an independent center of profit.
- Third persons pay the debts of the controllable corporation.
- The corporation has property which is used by a controlling person as if it were his own property.

We need to remember that the corporative law in the USA is mostly regulated by separate states [10] (and only some of the issues are settled in the Federal legislation). Correspondingly, speaking about the "piercing the veil" doctrine in the USA, one needs to specify which state is meant. In similar situations, the courts of one states can "pierce the veil", the courts of another state – cannot do it. With this, the variants of different states' legislations significantly influence each other and so very often it is just to speak about provisions common for all the states.

Reasons for "Piercing the Corporate Veil" by the Courts of England: In England, one of the reasons for "piercing the corporate veil" is the fact that the corporate structure is the "frontispiece hiding the real facts" [11]. This general principle was described in detail by the case law: the courts pierce the veil for prohibiting the usage of the corporate forms for fraud or to refuse to perform contractual or other legitimate obligations [12]; the courts can pierce the veil and make the shareholders personally liable in case of the illegal purposes or intentional concealing of the real state of things [13].

The second reason for "piercing the corporate veil" by the courts of England is discovering the Principal-Agent relations between the shareholder and the company when the latter practically loses its independence (for example, when the shareholder is the managing center for the company activities or appoints persons performing activities on behalf of the company) [14].

We need to specially note that the modern English court practice demonstrates the impermissibility of increasing the number of reasons for making a shareholder liable for the subsidiary company obligations [15].

General Provisions for "Piercing the Corporate Veil" by the Russian Courts: As for the continental jurisdictions, there is no doctrine of "piercing the veil" in them. However, the Russian legislation actually contains mechanisms which could be nominally named "the procedure of piercing the corporate veil" (Article 10 of the Federal Law on Bankruptcy – hereinafter referred as the Bankruptcy Law - [16], Articles 56 and 105 of the RF Civil Code).

In the Russian legal order, the concept of "piercing the veil" can be used in several cases: when bringing the principal companies to liability for the obligations of their subsidiaries; when bringing the so-called "directors-in-shadow" to liability – i.e. persons who are not the members of the managing structures but who define the actions of the legal person; for procedural means, when one person really involved into the definite legal relations can be liable for another person that is not formally a subject of the legal relations [17].

The general principle of the civil liability set by Article 56 of the RF Civil Code is that the establisher (member) of the legal person or the owner of its property is not liable for the obligations of this legal person and the legal person is not liable for the obligations of the establisher (member) or the owner, except for the cases listed in the RF Civil Code or in the corporate establishment documents. Articles 87, 96 of the RF Civil Code, Article 3 of Federal Law "On the Joint-Stock Companies (hereinafter referred as the Joint-Stock Company Law [18] and Article 3 of Federal Law "On the

Limited Liability Companies" (hereinafter referred as the Limited-Liability Company Law) [19] do not define the liability of the shareholders (members) of the economic companies for the obligations of these companies. The exception from the general rule of the shareholders (members) liability for the company obligations is the relations of economic dependence between the principal and the subsidiary companies.

The Russian Federation Civil Code (Item 2 of Article 105) and the Laws on the Business Companies (Item 3 of Article 6 of the Joint-Stock Company Law and Item 3 of Article 6 of the Limited-Liability Company Law) set two exceptions when establishing the liability of the principal company (partnership) for the obligations of the subsidiary: the solidary liability incurs for the deals performed by the subsidiary to follow the mandatory order by the principal company, in case this principal company has the right to give such orders to the subsidiary; the subsidiary responsibility for the debts of the subsidiary company incurs in case the principal company is guilty for the bankruptcy of the subsidiary company.

The regulation of bringing the principal economic company to subsidiary liability for the obligations of the subsidiary company in case of its bankruptcy caused by the guilty actions of the principal company complies with the general principle defined in Item 3 of Article 56 of the RF Civil Code about the liability of the establisher (member) of the legal person, the owner of its property or other persons having the right to give orders to this legal person mandatory for fulfillment, or to differently influence its activities, in case the legal person is a bankrupt. Similar norms are fixed in Item 3 of Article 6 of the Joint-Stock Company Law and Item 3 of Article 6 of the Limited-Liability Company Law.

The analysis of the legislation and the court practice allows to make the following conclusions about the character, reasons and the order of bringing the principal company to liability for the obligations of the subsidiary in case of its bankruptcy:

- This is the non-contractual liability: there are no contractual obligations between the creditor of the subsidiary and the principal company.
- The creditors of the subsidiary have the right to claim for the compensation, as well as the bankruptcy supervisor, in accordance with Item 5 of Article 129 of the Bankruptcy Law.
- The subsidiary status should be proved in court. In Russian conditions, the control can be proved (besides the direct evidence) by analyzing the following facts by the court:
  - If the principal and subsidiary companies have the same managers or common offices;
  - The principal company finances the subsidiary one;
  - Absence of the independent activity not associated with the principal company activity;
  - If the incorporation of the subsidiary company was initiated by the principal company;
  - If the principal company pays the salary to the employees of the subsidiary company or bears other expenditures of the latter;
  - The presence of significant (determinative) inter-crossings in the managing and controlling bodies; relative, close (other personal) relations between the members and the managers; common actual location of ordinary performers, centers for making decisions and document storage;
  - Performing the higher managing functions by persons who due to their education, the type of the main activity and position in other company are not able to actually perform these functions;
  - Systematic unprofitable transactions and other contracts which have no economic sense and reasons for the controllable subsidiary;
  - Common legal representatives and advisors in the sphere of the corporative activity including common contact persons and post addresses;
  - Of the principal company uses the property of the subsidiary as if it were its own;
  - If the subsidiary follows the general corporation formalities, such as keeping separate books and records and having separate meeting of the shareholders and the directors.

The mentioned criteria are not fixed anywhere by the Russian courts, in contrast to the courts of England and the USA and are developed separately for each individual case. The list given is based on the analysis of the existing court practice.

- The principal company should have the right to give mandatory orders to the subsidiary and define its activities in other ways (Article 56 of the RF Civil Code).
- The actual activities performed by the principal company proving the company's usage of its right to give such mandatory orders and/or other resources shall be proved in a judicial procedure.

However, in accordance with the law enforcement practice [20] the founders' failure to act can be the reason for bringing them to the subsidiary liability. This complies with Item 3 of Article 3 of the Joint-Stock Company Law,

in accordance with which the insolvency of the company can be caused by both shareholders' actions and their failure to act. With this, such close interpretation of the norm is not always supported by the court practice [21].

As for the limited liability company, the law does not prescribe for the failure-to-act liability of the principal company in case the subsidiary is a bankrupt.

- The causal relations between the right of the principal company to give mandatory orders and/or use other resources and the circumstances that led to the insolvency (bankruptcy) of the subsidiary company.
- The principle of the subsidiary (or supplementary) liability set in Item 1 of Article 399 of the RF Civil Code, gives the creditor the right to claim only in case the main debtor's property is not enough for the compensation. The courts consistently follow the position that the right for a claim to the members (shareholders) for bringing them to the subsidiary liability is granted to the creditors whose demands were not fully satisfied during the bankruptcy procedures.

The extent of liability of the principal company is defined based on the difference between the demands of the creditor and the money received after the debtor's property sale or replacing the assets of the debtor.

- For bringing a limited liability company to liability it is enough to prove its intentional guilt or guilt through negligence. As for its liability for the debts of its insolvent subsidiary, it is necessary to prove only the intentional guilt, what is extremely difficult in practice.

As we see, judging from the actual level of the Russian legislation and law enforcement practice, the conclusion can be made that, with a limited number of exceptions contained in the legal position of the supreme judicial authority, "piercing the corporate veil" in the Russian Federation, including that for the purposes of bringing the principal company to liability for the obligations of the subsidiary, is not an effectively operating legal institution. However, we cannot ignore the fact that recently a significant number of positive court decisions were made especially those associated with bankruptcy. As a rule, the managers and the members of the debtor company were brought to liability per Part 4, 5 of article 10 of the Bankruptcy Law [22,23,24]. It is obvious that in the nearest future the practice of "piercing the corporate veil" by the Russian courts will become wider and wider and in our opinion, it is necessary to clearly see the political and legal consequences of its development. Otherwise we will come to cancelling the limited liability. On the other hand, the state and the society need the tools to struggle against dishonest proprietors and corporate fraudsters. Thus, the mentioned legal institution should be used not for destroying the limited liability but for avoiding the unlimited irresponsibility.

With this, a number of researchers have an opinion that practicing such institutions based on the doctrines and other jurisdictions not formalized in the Russian law, is rather risky, because this may lead to the destruction of the concept of the individuality of the legal person and the limited liability institution; and this is inadmissible [25, 26]. If we do not want to fully ruin the legal person construction, then the "veil pierce" concept needs to be limited in its application in the legislation. However, as far as even the properly formulated definition can be easily bypassed, the court interpretation will have the decisive role. In any case, applying the mentioned doctrine should have exceptional (extraordinary) character, similar to the discussed foreign legal orders [27].

So, the mechanism of "piercing the corporate veil" needs to be worked out in detail, to provide for its unified usage by the courts. For the balanced application of the new norms, the courts will need to have a more thorough approach when studying the specific circumstances of the case and when interpreting the legal norms, because a number of novelties contain evaluative judgments which, with the expansive interpretation by the courts, can significantly change the very essence of the principle of the limited liability of the members and the shareholders for the obligations of the legal persons.

REFERENCES

1. Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes. OECD's Report, 2001. Paris, pp: 3.
2. Griggs, L. and G. Lugten, 2007. Veil Over the Nets Unravelling Corporate Liability for IUU Fishing Offences. Marine Policy, 31(2): 159-168.
3. Wormser, I.M., 1912. Piercing the Veil of Corporate Entity. Columbia Law Review, 12(6): 496-518.
4. Suslov, M.G. and T.M. Zhukova, 2013. What has Caused the Modern Economic Crisis. World Applied Sciences Journal, 25(6): 882-885.
5. Civil Code of the Russian Federation (Part One) of 30.11.1994 # 51-FZ (edition of 02.07.2013). Collected Legislation of the RF. 05.12.1994. # 32. Article 3301.

6. Decision of the RF Supreme Arbitration Court Presidium of 24.04.2012 # 16404/11 for case # A40-21127/11-98-184. RF Supreme Arbitration court Bulletin. 2012. # 10.
7. Richardson, M., 2011. The helter sketler application of the reverse piercing doctrine. University Of Cincinnati Law Review, 79(4): 1612-1613.
8. Thomason, M.A., 2011. Piercing the Corporate Veil. Facts and Findings Magazine, 29: 11-12.
9. Brown, D.S., 2012. Piercing the Corporate Veil: A General Overview of the Exception Creditors Can Use to Find Individual Shareholders Liable for Corporate Debts. Date Views 19.11.2013 www.weltman. com/ publications/articles/?i=547&NH.
10. Bebchuk, L., 2004-5. The Case for Increasing Shareholder Power. Harvard Law Review, 118: 833, 844.
11. Mendelsohn, J., 2010. Wisdom of Salomon. Legal Executive Journal. ISSN 0024-0362: 37.
12. Arthurs, C., 2012. To pierce or not to pierce? The Court of Appeal protects the corporate veil. The Commercial Litigation Journal, 7-8: 18.
13. Cheng, T.K. 2011. The corporate veil doctrine revisited: a comparative study of the English and the U.S. corporate veil doctrines. Boston College International and Comparative Law Review, 34(329): 382.
14. Nagel, A., 2013. Balancing entrepreneurial freedom and creditor protection in company and insolvency law: German and European Union perspectives. Australian Journal of Corporate Law, 27: 303.
15. Twomey, M. and R. Cowper, 2013. Who pulls the strings? New Law Journa, 163(7557): 605.
16. Federal law, "On Insolvency (Bankruptcy)" of 26.10.2002 # 127-FZ (edition of 28.06.2013). Collected Legislation of the RF. 28.10.2002. # 43. Article 4190.
17. Interview with Irina Sergeevna Shitkina, 2012. Doctor of Juridical Sciences, Professor, Head of Master Program "Corporate Law" in Moscow State University n.a. M. Lomonosov. Lawyer.17: 5.
18. Federal Law, 1996. "On the Joint-Stock Companies" of 26.12.1995 # 208-FZ (edition of 05.04.2013). Collected Legislation of the RF. 01.01.1996. 1. Art. 1.
19. Federal Law, 1998. "On Limited Liability Companies" of 08.02.1998 Volume 14-FZ (edition of 29.12.2012). Collected Legislation of the RF. 16.02. 1998. 7. Art. 785.
20. Regulation of FAS of the Moscow Region of 30.04.2003 # KG-A40/2221-03. Reference Legal System "Consultant Plus".
21. Regulation of the RF FAS of 12.12.2007 # 15888/07 for case # A45-3930/07-43/3-51. Reference Legal System "Consultant Plus".
22. Decision of the RF Supreme Arbitration Court Presidium of 06.11.2012 # 9127/12, of 07.06.2012 # 219/12.
23. Decision of the RF Supreme Arbitration Court of 11.02.2013 # BAC-14858/12, of 11.07.2011 for case # VAS 8023/11. Reference Legal System "Consultant Plus".
24. Regulation of FAS of the Moscow Region of 18.02.2013 for case # A40-61071/11-103-6b, of 11.01.2010 # KG-A40/13661-09. Reference Legal System "Consultant Plus".
25. Budylin, S.L. and Y.L. Ivanets, 2013. Piercing the Veils. The Doctrine of Piercing the Veil in Foreign Countries and in Russia. Newsletter of the Higher Supreme Court of the Russian Federation, 7: 80-125.
26. Karnakov, Y.V., 2009. "Piercing the Corporative Veil" in the Draft Concept of the Legal Person Legislation Development. Russian Law: Education, Practice, Science, 9 (62): 31-36.
27. Criswell, P.L., 2005. Veil Piercing, Some Practical Guidelines. The Independent Counsel, 12(10): 93.