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COMMENT

Piercing China's Corporate Veil: Open Questions from the New Company Law

In 2006, China undertook a major overhaul of its legal framework governing corporations by implementing a new Company Law.[1] Much of the previous Company Law was revised or eliminated, with many new provisions added.[2] This development was much anticipated by Chinese and foreigners alike, as China's previous corporate law was unable to keep pace with its fast-growing economy.[3] One of the highlights of the new Company Law is its formal establishment of the concept of "piercing the corporate veil" in Chinese law.

The concept of piercing the corporate veil is a longstanding feature of the corporate law of capitalist economies. An important corporate form in such economies is the limited liability corporation (LLC), a key attribute of which is that shareholders are not personally liable for corporate debts in excess of their investment in the LLC. Creditors seeking payment of debts or tort victims seeking redress generally can reach only the corporation's assets, not those of its shareholders. At times, however, courts ignore this corporate fiction and treat a corporation's debt as the debt of the corporation's shareholders. In doing so, courts "pierce the corporate veil."

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1. Gongsi fa [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) LAWINFOCHINA (last visited Aug. 30, 2007) (P.R.C.) [hereinafter 2006 P.R.C. Company Law].

2. Baoshu Wang & Hui Huang, *China's New Company Law and Securities Law: An Overview and Assessment*, 19 AUSTL. J. CORP. L. 229, 231-32 (2006) (noting that of the 229 provisions of the 1994 Company Law, 46 provisions had been deleted and 137 amended, with 41 new provisions added).

3. For a discussion of shortcomings in the 1994 Company Law, see, for example, GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW 312-17 (2006); Nicholas C. Howson, *China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint*, 11 COLUM. J. ASIAN L. 127, 140-72 (1997); Baoshu Wang & Hui Huang, *supra* note 2, at 229-31.

The notion of piercing the corporate veil did not exist formally in Chinese statutory law prior to 2006. The new Company Law, however, allows courts to pierce the corporate veil under certain circumstances. In doing so, it aligns Chinese corporate law more closely with that of other market economies.

While this change is welcome, China's new Company Law fails to address important questions about the veil-piercing doctrine. This ambiguity negatively affects several constituencies. Creditors lack certainty about when they can expect to recover from a bankrupt debtor whose shareholders may have operated illegally. Shareholders lack clear guidance about what constitutes abuses of the corporate form against which they should monitor. Ordinary citizens harmed by tortious acts lack clarity about when they can tap into the deep pockets of parent corporations. Finally, foreigners who lend funds to Chinese companies, contract with or invest in shares of Chinese subsidiaries, or establish their own subsidiaries in China are denied a clear sense of the legal rules at play.

This Comment highlights legal ambiguities on two fronts—how the law is to be applied, and what its scope is. These shortcomings should be addressed in one of two ways. Either the State Council should promulgate additional regulations related to the new Company Law, or the Supreme People's Court (SPC) should issue to lower courts a judicial interpretation that establishes guidelines on how the new Company Law should be interpreted.[4] Unless one of these steps is taken, creditors, investors, and shareholders alike will face continued uncertainty about when courts can pierce a corporate veil.

I. DEVELOPMENTS IN CHINESE VEIL PIERCING

Prior to 2006, China's veil-piercing doctrine operated in a state of uncertainty. Not until the 1990s, with the rise of the LLC as a corporate form in China, did the notion of a corporate veil become important.[5] In 1994, Chinese law formally recognized LLCs as "legal person[s]" with shareholder liability limited to the extent of the shareholder's "capital contributions" or "shareholdings."[6] However, the 1994 Company Law did not grant Chinese courts the right to pierce the corporate veil. Nor did any other statute confer

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4. For an overview of the Chinese legal system including the role of the SPC's judicial interpretations and State Council regulations, see, for example, Peter Howard Corne, *Creation and Application of Law in the PRC*, 50 AM. J. COMP. L. 369 (2002).

5. Note, however, that the LLC as a corporate form has been available under Chinese law since 1951 for private corporations. *See* Chuan Roger Peng, Note, *Limited Liability in China: A Partial Reading of China's Company Law of 1994*, 10 COLUM. J. ASIAN L. 263, 266 (1996).

6. Gongsi fa [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994), art. 3, ISINOLAW (last visited Aug. 30, 2007) (P.R.C.).

such power.[7] As a result, most Chinese commentators agreed that China's law did not include piercing the corporate veil.[8]

Despite the absence of an express statute, some enterprising Chinese judges implemented the concept informally during this period. For example, in replying to an inquiry made by the High Court of Guangdong province, the SPC implied that veil piercing may be permissible when the actual capital contribution made to a corporation is less than the amount of capital registered under that corporation.[9] The SPC has also affirmed a number of lower court decisions that pierced the corporate veil.[10]

These cases, however, failed to establish clearly the doctrine of piercing the corporate veil for three reasons. First, because China is governed by civil law, cases hold no precedential value.[11] Second, the SPC's own case law suggested a mixed jurisprudence. The court reversed lower court decisions to pierce the corporate veil in cases that were factually similar to cases it affirmed.[12] Finally,

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7. Note that under article 61 of the General Principles of Civil Law, any party whose juristic act is held void because of fraud, deception, violation, or unlawful purpose is required to return all properties it has obtained by the void act and to compensate the victim. This civil liability, however, is limited by article 48, which stipulates that a state-owned enterprise is liable only to the extent of the property that has been granted by the state for its operation. Other enterprises are liable only to the extent of the property that they own. Minfa tongze [General Principles of the Civil Law] (adopted by the Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), arts. 48 & 61, ISINOLAW (last visited Aug. 30, 2007) (P.R.C.).

8. Zhang Xianchu, *Piercing the Company Veil and Regulation of Companies in China*, *in* LEGAL DEVELOPMENTS IN CHINA: MARKET ECONOMY AND LAW 129, 132 (Wang Guiguo & Wei Zhenying eds., 1996); Weiguo He, Legal Transplantation of "Piercing the Corporate Veil" to China 8 (n.d.) (unpublished manuscript), *available at* http://lsa.mcgill.ca/aplam/ChineseArticles/Legal%20Transplantation%20of%20Piercing%20the%20Corporate%20Veil%20to%20China%20%20by%20Weiguo%20He.pdf (last visited Aug. 30, 2007) (citing JUNHAI LIU, PROTECTION FOR SHAREHOLDERS' RIGHTS IN CORPORATIONS LIMITED BY SHARES 362 (1997)).

9. Guanyu qiye kaiban de qita qiye bei chexiao huozhe xieye hou minshi zeren chengdan wenti de pifu [On the Assumption of Civil Liability After an Enterprise Established by Another Enterprise Has Been Closed or Gone Out of Business] (Reply of the SPC to High Court of Guangdong, Mar. 30, 1994) (No. 1994[4]) CHINALAWINFO (last visited Aug. 15, 2007) (P.R.C.).

10. Zhang Xianchu, *supra* note 8, at 134-35 (highlighting examples of piercing cases that the SPC affirmed).

11. However, the Supreme People's Court can make a legal principle binding on a lower court by issuing a judicial interpretation on a topic. Thus, under the Chinese legal system, it is through judicial interpretations rather than precedents that the Supreme People's Court performs statutory interpretation and enacts legal principles.

12. *See* Zhang Xianchu, *supra* note 8, at 135-37 (discussing a case in which the SPC reversed a decision to pierce the corporate veil when the company had been undercapitalized, and a case in which the SPC reversed a decision to pierce the corporate veil despite the parent company's de facto control over the subsidiary).

veil piercing occurred in only selected provincial courts.[13] A uniform principle did not exist across China.

This all changed with the 2006 revisions to the Company Law. Article 20 of the law states: "Where any of the shareholders of a company evades the payment of its debts by abusing the independent status of juridical persons or the shareholder's limited liabilities, and thus seriously damages the interests of any creditors, it shall bear joint liabilities for the debts of the company."[14] In addition, article 64 provides a veil-piercing provision relevant to single-shareholder LLCs. It states: "If the shareholder of a one-person limited liability company is unable to prove that the property of the one-person limited liability company is independent from his own property, he shall bear joint liabilities for the debts of the company."[15]

II. CRITIQUING CHINA'S NEW VEIL-PIERCING PROVISIONS

Because of the relative lack of public transparency surrounding China's statutory drafting process, one can only speculate about why Chinese lawmakers felt compelled to include veil-piercing provisions in the new Company Law. There are at least three feasible motives. First, given China's burgeoning economy and the rising importance of LLCs, the government may have wanted to provide greater clarity to investors and creditors alike about when, if ever, veil piercing might occur. In other words, it did not want legal uncertainty to constrain the development and growth of LLCs artificially. Second, the central government may have wanted to rein in enterprising judges and ensure greater uniformity in the doctrine's application across lower courts. Third, the government may have wanted to strengthen the judiciary's hand in combating corporate fraud. The National People's Congress Standing Committee report on amending the Company Law specifically mentions the problem of shareholders abusing the corporate form by illicitly transferring

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13. *See, e.g.*, Beijing Chengxiang Haodu Constr. Co. v. Yang Jingui, CHINALAWINFO (Beijing High People's Ct., July 31, 2002). *But see, e.g.*, Japan Yueliangren Zhenzhi Co. v. Nantong Richu Fuzhuang Co., CHINALAWINFO (Nantong Interm. People's Ct., Nov. 14, 2001). The high courts of Guangdong, Guangxi, and Ningxia provinces have pierced the corporate veil. *See* Zhang Xianchu, *supra* note 8, at 135-37. The high court of Tianjin Municipality has also pierced the corporate veil. *See* Zhu Ciyun, *Bixu zunzhong he weihu gongsi de duli renge* [*The Necessity of Respecting and Protecting the Corporation as an Independent Entity*], *in* 2 ZHONGGUO ANLI ZHIDAO: MINSHI JUAN [GUIDANCE ON CHINESE CASES: CIVIL LAW] 387, 391 (2006) (describing a case where the court found that the illegal conversion of corporate assets for personal use justified veil piercing).

14. 2006 P.R.C. Company Law art. 20.

15. *Id.* art. 64.

and commingling corporate assets.[16] Formal legal recognition of the power to pierce the corporate veil deters against such abuse.

However, articles 20 and 64 are only partially successful in accomplishing the goals above. While the veil-piercing provisions are a welcome addition to Chinese law, China's nascent doctrine falls short in two areas. First, the 2006 Company Law provides insufficient guidance to courts about how to proceed with analyzing a veil-piercing case. Second, the law's scope is unclear, or otherwise, too narrowly constrained. These shortcomings mean that considerable uncertainty remains for those who invest in or lend to LLCs. In addition, the extent of the judiciary's power to pierce the corporate veil, as well as limitations on this power, remain less than clear.

To see how such problems may arise, consider the text of the two articles providing the court with the power to pierce the corporate veil. Article 20 directly discusses only two factors that courts should consider: (1) whether the abuse results in debt nonrepayment; and (2) whether this nonrepayment causes actual injury to a party.[17] Article 64 raises another factor: the commingling of assets.[18] The law is unclear about whether these are the only factors that courts are to consider, or alternatively, whether courts may consider additional factors when adjudicating a demand to pierce the corporate veil.

For example, the law makes no mention of whether or not the existence of fraud is a factor that a court may consider. Under the Anglo-American system, fraud is not a necessary prerequisite. Plaintiffs can seek to pierce the corporate veil even when the corporation did not seek to defraud its creditors. Some civil law jurisdictions, including Japan and Germany, have adopted a similar system.[19] Under the French system, however, a plaintiff must show that a corporation committed one of three types of fraud before courts will pierce the

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16. Zhu Ciyun, "Ziben buzu" zai Gongsi fa renge fouren shiyong zhong de yiyi ["Undercapitalization" and the Principle of Disregarding the Corporate Entity Under the Company Law] 1 (n.d.) (unpublished manuscript, on file with The Yale Law Journal), *available at* http://www.fatianxia.com/paper_list.asp?id=22670 (last visited Aug. 30, 2007).

17. 2006 P.R.C. Company Law art. 20.

18. *Id.* art. 64.

19. GERHARD WIRTH, MICHAEL ARNOLD & MARK GREENE, CORPORATE LAW IN GERMANY 23-24 (2004) (stating that German courts consider factors including commingling of assets, de facto control, grossly negligent conduct, and undercapitalization); Misao Tatsuta, *A Parent Corporation's Liability for Its Subsidiary's Obligations*, *in* LAW AND INVESTMENT IN JAPAN 338, 340 (Yukio Yanigada et al. eds., 2000) (noting that Japanese courts consider whether the parent company possesses effective control over the subsidiary and the position of creditors in relation to the subsidiary). However, Japanese law does provide stronger remedies in the instance of fraud, namely the dissolution of the fraudulent corporate entity. *See* SHŌHŌ [Commercial Code], art. 141 (Japan).

corporate veil. The corporation must have knowingly engaged in unlawful action, set out to intentionally conceal the nature of the transaction, or deliberately engaged in fraudulent conduct concerning a company's separate existence.[20] China's new law does not take a position on this divide. From a textual perspective, it does not appear to require proof of fraud. Yet, do judges have the flexibility to consider fraud as an additional factor when adjudicating? Or are they constrained by the factors delineated in articles 20 and 64?

If the law grants judges the flexibility to consider additional factors, then the new law is problematic because it fails to set clear boundaries on how judges should analyze a veil-piercing case.[21] Local judicial officials can craft their own multifactor analyses, which raises the possibility that decisions will reflect local protectionist interests.[22] It also weakens the integrity of judicial review, since higher-level courts can effectively decide whether to uphold or reverse a lower court's decision on a veil-piercing case based on their own set of arbitrary criteria designed to achieve a desired outcome.

On the other hand, if the factors listed in articles 20 and 64 are a closed set, that would raise a different concern. The new law explicitly discusses only the rights of creditors. Although bankruptcies are an important context in which veil piercing is invoked, they are, by no means, the only ones. China's courts are bound to face demands to pierce the corporate veil in noncreditor situations in the coming years. Environmental class action lawsuits are on the rise,[23] as China confronts major environmental problems. In addition, with increased worries about product safety, Chinese consumers are likely to seek greater enforcement of consumer protection laws. A narrow textualist interpretation of the new Company Law suggests that the Company Law's veil-piercing provisions may not cover all such litigants. Article 20's scope, if read literally, applies only to debt situations. As a result, China's new veil-piercing provisions are either too narrow or, at best, ambiguous in their applicable scope.

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20. STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 5:4 (2007).

21. *Cf.* Liu Jun-hai, *Xin gongsi fa zhong jiekai gongsi miansha zhidu de jieshi nandian tanxi* [*An Analysis of the Controversial Issues of Piercing the Corporate Veil in the Context of the New Corporate Law*], 17 TONGJI U. J. SOC. SCI. SEC. 111, 115 (2006) (noting that one of the problems with the law is its failure to provide judges with guidance on how to determine what constitutes "abuse" under article 20).

22. For a discussion of the problems of local protectionism in the Chinese judiciary, see, for example, XIN CHUNYING, CHINESE COURTS: HISTORY AND TRANSITION 185-214 (2004); Donald C. Clarke, *China's Legal System and the WTO: Prospects for Compliance*, 2 WASH. U. GLOBAL STUD. L. REV. 97, 106-07 (2003); Pitman B. Potter, *The Legal Implications of China's Accession to the WTO*, CHINA Q., Sept. 2001, at 592, 601-02.

23. Sarah Schafer, *Taking China to Court*, NEWSWEEK INT'L, Nov. 20, 2006, http://www.msnbc.msn.com/id/15672081/site/newsweek/.

III. A PROPOSAL FOR ENHANCING CHINA'S VEIL-PIERCING DOCTRINE

Veil-piercing cases are highly fact specific, and some degree of judicial flexibility is desirable. Nevertheless, Chinese corporate law would benefit from more clearly delineating its applicable scope and the factors to be considered by courts in a veil-piercing case.

The SPC or the State Council should clarify how courts should consider a demand to pierce the corporate veil.[24] It should specify that the factors mentioned in articles 20 and 64 of the Company Law are not exclusive and clarify additional factors that courts may consider when adjudicating such cases.[25] Doing so will provide greater clarity to judges, shareholders, investors, and creditors about how the legal analysis should proceed in a veil-piercing case.

Delineating a multifactor list is common in other jurisdictions. U.S. courts commonly rely upon a set of eleven factors outlined by Frederick Powell in the 1930s.[26] More recent commentators have suggested as many as thirty-one factors that should be taken into account.[27] German courts have also adopted a set of factors similar to those used by U.S. courts, including commingling of assets, failure to follow formalities, undercapitalization of assets, and the extent to which one company dominates another.[28] Japanese lower courts have also constructed a similar list of factors for deciding veil-piercing cases.[29]

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24. Some Chinese scholars have also called for such a clarification. *See, e.g.*, Zhu Yunfang, *Jiekai gongsi de miansha: Gudong chengdan liandai zeren de goucheng yaojian* [*Piercing the Corporate Veil: Essential Elements of Shareholders' Joint Liability*], 20 J. JINLING INST. TECH. 29, 31 (2006).

25. A small number of Chinese scholars themselves have debated the utility of delineating a list of factors that should be considered in a veil-piercing case. *Compare* Zhu Yunfang, *supra* note 24 (stressing the need to explain five sets of factors in a judicial interpretation) *with* Xu Qiong, *Jiekai gongsi renge fouren lilun de miansha* [*Uncovering the Veil of the Theory Behind Disregarding the Corporate Entity*], 8 J. UNIV. ECON. SCI. TECH. CHINA (SOC. SCI. ED.) 83, 84-85 (2006) (arguing that multifactor approaches are inherently vague and problematic).

26. FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 9 (1931).

27. Cathy S. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENV. L.J. 1, 52-55 (1978).

28. PRESSER, *supra* note 20, § 5:5.

29. *Id.* § 5.6 (noting that such factors include the commingling of assets, repeated overlap of business transactions or activities, failure to follow corporate formalities, inadequate capitalization, and lack of a separate identity between corporation and individual).

Among the factors[30] that Chinese courts should analyze in any veil-piercing case are:

(1) Whether the company is undercapitalized, which was a major factor in cases prior to the 2006 Company Law.[31] An undercapitalization analysis should also include whether creditors were intentionally misled about the financial strength of the corporation.
(2) Whether the corporation failed to observe corporate formalities, such as holding separate board meetings, keeping separate records, maintaining separate offices and accounts, filing separate tax returns, and holding separate deeds to property.
(3) Whether corporate assets were diverted for personal use.[32] Such diversion, if it occurs without payment or prior agreement, is often evidence of an alter-ego relationship between the shareholder and the corporation.
(4) Whether the corporation failed to issue any stock, maintain real property, buy separate insurance, or engage in other conduct typical of a normal corporation.
(5) Whether the parent company interfered excessively in the management of the subsidiary.
(6) Whether the parent and subsidiary companies conducted joint activities, such as purchasing, advertising, or public relations, and if so, whether payment for such activities was unfairly distributed across the two companies.

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30. Note that this is a suggestive, rather than an exhaustive, list. These factors are among those most commonly considered by courts in other jurisdictions, and in some instances, involve a combination of factors that are separately delineated. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 4.3, at 156-61 (2002); JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 7.08, at 280-81 (2d ed. 2003). U.S. cases that have applied a multifactor balancing test include *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976); *Amoco Chemical Corp. v. Bach*, 567 P.2d 1337, 1341-42 (Kan. 1977); and *Attorney General v. M.C.K., Inc.*, 736 N.E.2d 373, 380 n.19 (Mass. 2000).

31. A number of Chinese scholars have emphasized the importance of this factor. *See, e.g.*, Liu Jun-hai, *supra* note 21, at 115-16; Liu Li, *Jiekai gongsi de miansha: Gongsi faren renge fouren zhidu de shiyong* [*Piercing the Corporate Veil: On the Application of Disregarding the Corporate Entity*], 23 J. HUBEI INST. EDUC. 83, 85 (2006); Zhu Yunfang, *supra* note 24, at 31; Zhu Ciyun, *supra* note 16, at 2-3.

32. Some Chinese courts and scholars have stressed the importance of this factor. *See, e.g.*, Beijing Chengxiang Haodu Constr. Co. v. Yang Jingui, CHINALAWINFO (Beijing High People's Ct., July 31, 2002); Zhu Ciyun, *supra* note 16.

(7) Whether the corporation concealed or misrepresented the responsible ownership, management, or financial interests in the corporation, or concealed the personal business interests of the shareholders.

(8) Whether the corporation failed to pay or overpaid dividends to shareholders.[33]

Should China proceed down such a path, it ought to stipulate how courts are to balance the various factors considered in their analysis. Given the rapidly evolving transformation of its market economy, China would be best served by a "totality of the circumstances" test. The totality of the circumstances test requires courts to consider the overall context under which the alleged suspicious or fraudulent corporate activity occurred, in addition to the specific factors. Not every prong of the multifactor test need be present, but the more that are, the more likely it is that a court will pierce the corporate veil. This test has been used by some American courts under the guise of an equity theory,[34] and evolved from criticisms that previous theories of veil piercing applied by courts were "[i]n practice . . . virtually indistinguishable from one another."[35] Applying a multifactor analysis and test would offer both greater certainty about the legal test in veil-piercing cases and greater flexibility for courts to consider the individual factual circumstances of each case.

Finally, the SPC or State Council should clarify the applicable scope of the veil-piercing provisions of the new Company Law. China should clarify that the provisions apply in noncreditor contexts. Other jurisdictions have applied the doctrine more broadly. For example, in the United States, if the corporate form has been abused and the assets of the tortfeasor are insufficient, courts will mandate that a parent company compensate tort victims.[36] U.S. courts have also created an exception for public policy,[37] which courts have applied in antitrust cases to strike down "shell companies" established to circumvent

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33. Chinese scholars have disagreed about this factor's relevance. *Compare* Liu Li, *supra* note 31, at 85 (emphazing its importance), *with* Xu Qiong, *supra* note 25, at 84 (discounting its importance).

34. *See, e.g.*, *DeWitt Truck Brokers*, 540 F.2d 681; White v. Winchester Land Dev. Corp., 584 S.W.2d 56 (Ky. Ct. App. 1979).

35. COX & HAZEN, *supra* note 30, § 7.08, at 279.

36. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1058-59, 1068-70 (1991).

37. *See, e.g.*, Love v. State, 972 S.W.2d 114 (Tex. App. 1998) (piercing the corporate veil because using limited corporate liability to avoid pollution statutes is contrary to public policy).

antitrust laws.[38] Similarly, Japanese courts have allowed veil piercing in contexts such as violations of noncompetition agreements and unfair labor practices.[39] Chinese judges, shareholders, investors, and potential noncreditor plaintiffs alike would benefit from knowing under exactly what circumstances Chinese courts can disregard the corporate form.

CONCLUSION

Formally recognizing veil piercing ends more than a decade of uncertainty over whether Chinese judges can pierce corporate veils. However, the new law is incomplete and introduces new problems. To correct these problems, the SPC or the State Council should issue additional directives to clarify China's veil-piercing doctrine. Specifically, directives should address the set of factors that courts may consider in veil-piercing cases and how these factors should be balanced in a "totality of the circumstances" test. In addition, China should consider expanding veil piercing to antitrust and other contexts. Doing so would bring China's veil-piercing doctrine more in line with international practice.

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38. *See, e.g.*, Zale Corp. v. FTC, 473 F.2d 1317 (5th Cir. 1973); United States v. Ira S. Bushey & Sons, Inc., 363 F. Supp. 110 (D. Vt. 1973).

39. Hiroyuki Tezuka, *Piercing Corporate Structures in Japan* 1995 ABA.—I.P.B.A. DISP. RESOL. PAC. RIM 4, 12.