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Clearing Away the Mist: Suggestions for Developing a Principled Veil Piercing Doctrine in China

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Clearing Away the Mist: Suggestions for Developing a Principled Veil Piercing Doctrine in China

ABSTRACT

It was less than thirty years ago that China stood economically isolated from the rest of the world. Times have certainly changed. Today China's economy is one of the fastest growing in the world, and Western businesses are inundating the country to access the abundance of cheap labor. Corporate activity is progressing, yet it was only twelve years ago that China enacted its first corporate law which officially recognized the concept of limited liability. And it was not until less than a year ago that China recognized one of the most important (and most often litigated) corporate law doctrines: piercing the corporate veil.

This Note considers how the veil piercing doctrine fits into China's civil law system. In the United States, the doctrine has developed progressively through the courts. This Note argues that, contrary to the U.S. doctrine, veil piercing in China must be codified with specificity if it is to play a significant role. In particular, the statute must lay out guidelines for Chinese courts to follow when deciding whether to pierce the veil. The current veil piercing statute, enacted in January 2006, is too ambiguous to be useful. If left unchanged, it will likely produce the same confusion and unpredictability that has plagued the doctrine in the United States. As a result, this Note suggests specific guidelines that could be codified to avoid this result and to strengthen the doctrine's usefulness in China's civil law system.

TABLE OF CONTENTS

I.	INTRODUCTION	1644
II.	LIMITED LIABILITY AND VEIL PIERCING.....	1645
	A. <i>Limited Liability</i>	1645
	B. <i>Piercing the Corporate Veil</i>	1649
III.	CHINA: ITS POLITICS, ECONOMY, AND COMPANY LAW ..	1652
	A. <i>China's Economy</i>	1652
	B. <i>The Company Law</i>	1655
	C. <i>Piercing the Veil in China</i>	1661
IV.	REFINING CHINA'S STATUTORY VEIL PIERCING DOCTRINE	1667

A.	<i>Distinguishing Between the Parent-Subsidiary Context and the Human Context</i>	1668
B.	<i>Distinguishing Between Tort and Contract Creditors</i>	1674
V.	CONCLUSION.....	1675

I. INTRODUCTION

Judge Cardozo once famously described the concept of piercing the corporate veil as being “enveloped in the mists of metaphor.”¹ Despite the passage of eighty years, his colorful description of corporate veil piercing continues to be as timely and relevant as ever. Perhaps one fact best exemplifies the continued truth of his statement: “[p]iercing the corporate veil is the most litigated issue in [U.S.] corporate law.”² The concept is not unique to U.S. law, however. Nearly all developed economies have adopted concepts analogous to the U.S. veil piercing doctrine.³ Until quite recently, a notable exception had been China, one of the world’s fastest growing economies.⁴ However, China formally recognized the doctrine of veil piercing when the revised Company Law of China became effective on January 1, 2006.⁵

This Note explores China’s veil piercing doctrine. Before delving into Chinese law, and in order to establish a background for reference, Part II explains the concept of limited liability as it is

1. *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926), *reh’g denied*, 155 N.E. 914 (N.Y. 1927).

2. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991).

3. “Lifting the corporate veil” is the term used to describe veil piercing in England. STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* § 5:3 (West 2004) (1991). In Germany, the doctrine of piercing the corporate veil is known as “Durchgriffshaftung.” *Id.* § 5:5. The Japanese law which concerns veil piercing is called “hinin hojinkaku,” which translates as “disregarding the corporate personality.” *Id.* § 5:6. Argentinean courts have been piercing the corporate veil, there known as “abuso de la personalidad juridica,” since the 1930s. *Id.* § 5:2. France’s piercing doctrine resembles the doctrine in Argentina. *Id.*

4. Prior to the amended Company Law becoming effective in January 2006, Chinese courts had recognized veil piercing under only the most limited circumstances. *See infra* text accompanying notes 170–181. However, since China is a civil law country and the power of the courts is quite restricted, the doctrine had no real standing in Chinese corporate law until it was codified in the amended Company Law. *See infra* notes 186–93.

5. *See* The Company Law of the People’s Republic of China (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1993, effective July 1, 1994, amended Oct. 27, 2005, effective Jan. 1, 2006), *available at* <http://www.fdi.gov.cn/reupload/epdf/e04457.pdf> [hereinafter *The Company Law*].

generally understood. This Part also defines piercing the corporate veil and discusses its application in U.S. jurisdictions. Having laid the foundation, Part III begins the analysis of Chinese law with a brief recitation of China's political and economic history over the past sixty years, followed by a more detailed discussion of the general framework of the Company Law and its key characteristics. Also, Part III examines the current state of veil piercing in China. China's civil law system mandates that the doctrine be codified in a statute rather than developing through common law—as has been the experience in U.S. jurisdictions.⁶ This Part concludes with a discussion of some of the advantages and disadvantages of the statutory and common law approaches. Part IV argues that the veil piercing provision in the Company Law is inadequate. Because China is a civil law country and because its courts have very little discretion to adjudicate cases outside the four corners of the statute, the provision needs more specificity as to the factors that courts should consider when deciding whether to pierce the corporate veil. In particular, the Company Law should distinguish between situations where a creditor seeks to pierce to reach another corporation and where a creditor seeks to reach an individual. The history of veil piercing in the U.S. suggests that the two situations require different analyses, and therefore, the Company Law should delineate with some degree of specificity the factors that courts should consider in each case. Finally, the Company Law should distinguish between voluntary (contract) and involuntary (tort) creditors.

II. LIMITED LIABILITY AND VEIL PIERCING

A. *Limited Liability*

Limited liability is perhaps *the* distinguishing feature of corporate law.⁷ Limited liability means that investors in a corporation are not responsible for more than their capital contributions to the

6. See Robert B. Thompson, *Piercing the Veil: Is the Common Law the Problem?*, 37 CONN. L. REV. 619, 623 (2005).

7. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 40 (1991). Professor Presser noted: "It is now accepted as one of the first principles of American law that those who own shares in corporations, whether such shareholders are individuals or are themselves corporations, normally are not liable for the debts of their corporations." PRESSER, *supra* note 3, § 1:1.

The president of Columbia University also commented on the importance of limited liability: "[T]he limited liability corporation is the greatest single discovery of modern times [and] even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it . . ." *Id.* § 1:1 (quoting President Butler of Columbia University).

corporation.⁸ Likewise, a corporation's managers and workers are not vicariously liable for the firm's debts or other obligations.⁹ Because of limited liability, a corporation is considered its own legal "person"—it is an entity separate from its shareholders, directors, or officers.¹⁰

The rationale for and advantages of limited liability are several-fold. First, "limited liability allows [for] more efficient diversification."¹¹ Limited liability permits investors to decrease their exposure to risk by owning diversified portfolios of assets.¹² If unlimited liability existed, the risk faced by an investor would turn on the wealth of other investors because creditors would be more likely to go after the wealthiest of the investors.¹³ Therefore, diversification in the context of unlimited liability would increase rather than decrease the risk faced by investors. "If any one firm went bankrupt, an investor could lose his entire wealth,"¹⁴ so he would therefore invest in a relatively few number of firms and monitor those firms more closely. Said differently, if an investor had to supply unlimited amounts of capital to satisfy a corporation's obligations, "[he] would be reluctant to make small investments."¹⁵ Rather than many smaller investments, people would make relatively fewer larger investments.¹⁶ The result would be lower economic activity.¹⁷

8. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89–90 (1985); Thompson, *supra* note 2, at 1039. For example, "[a] person who pays \$100 for stock risks [only] that \$100" and nothing more. EASTERBROOK & FISCHEL, *supra* note 7, at 40. Likewise, a person who buys a bond for \$100 risks only \$100. *Id.*

The corporate veil is another way of expressing the basic principle that a corporation's shareholders will not be held liable for the obligations of the corporation. David M. Albert, Comment, *Addressing Abuse of the Corporate Entity in the People's Republic of China: New Thoughts on China's Need for a Defined Veil Piercing Doctrine*, 23 U. PA. J. INT'L ECON. L. 873, 873–74 (2002).

9. Easterbrook & Fischel, *supra* note 8, at 90. "[E]asily the most distinctive attribute of the corporation is its existence in the eye of the law as a legal entity and artificial personality distinct and separate from the stockholders and officers who compose it . . ." I. MAURICE WORMSER, *DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS* 11 (1929).

10. Thompson, *supra* note 2, at 1039.

11. EASTERBROOK & FISCHEL, *supra* note 7, at 43. Diversification is "the act of investing in a wide range of companies to reduce the risk if one sector of the market suffers losses." BLACK'S LAW DICTIONARY 511 (8th ed. 2004).

12. EASTERBROOK & FISCHEL, *supra* note 7, at 43.

13. See Thompson, *supra* note 2, at 1040. For example, if Shareholder X was worth \$100 and Shareholder Y was worth \$100,000, the creditors would seek to recoup their losses by going after Shareholder Y since he has more assets.

14. EASTERBROOK & FISCHEL, *supra* note 7, at 43.

15. Easterbrook & Fischel, *supra* note 8, at 90. "The rational strategy under unlimited liability . . . would be to minimize the number of securities held." *Id.* at 97.

16. See *id.* at 90.

17. Thompson, *supra* note 2, at 1040. Concurrently, investors would be forced to bear risk that diversification would have enabled them to avoid, "and the cost to

Additionally, “[l]imited liability decreases the need to monitor agents.”¹⁸ The agency-problem¹⁹ is inherent in the corporate setting, and “investors risk losing wealth because of the actions of [their] agents.”²⁰ Therefore, the more risk that investors bear, the more they will monitor their agents.²¹ However, because limited liability permits investors to diversify their investments, investors will be encouraged to hold a larger number of investments, with a smaller portion of their wealth invested in any one firm.²² Diversified investors have neither the incentive²³ nor the expertise to monitor the actions of specialized agents, so passivity is a more rational strategy. In turn, the decreased need to monitor the agents potentially reduces the costs of operating the corporation.²⁴

The costs of monitoring other shareholders are also reduced by limited liability.²⁵ As already discussed, if unlimited liability were the rule, “the greater the wealth of other shareholders, the lower the probability that any one shareholder’s assets would be needed to pay a judgment” against the corporation.²⁶ Therefore, existing shareholders would have incentives to monitor (presumably at some cost) other shareholders “to ensure that they do not transfer assets to others or sell to others with less wealth.”²⁷ Limited liability renders irrelevant the identity and wealth of other investors, and therefore avoids these costs.²⁸

Because limited liability promotes the free transfer of shares, it gives managers incentives to act efficiently.²⁹ The ability of investors to sell their ownership interests constrains the actions of agents.³⁰ Investors respond to inefficient enterprises by disinvesting.³¹ Assuming shares are tied to votes, “poorly run enterprises will attract new investors who can . . . install new managerial teams.”³² The

firms of raising capital would be greater.” EASTERBROOK & FISCHEL, *supra* note 7, at 43.

18. EASTERBROOK & FISCHEL, *supra* note 7, at 41.

19. See Seth W. Ashby, Note, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 535–38 (2005).

20. Easterbrook & Fischel, *supra* note 8, at 94.

21. *Id.*

22. *Id.*

23. “Because investors’ potential losses are ‘limited’ to the amount of their investment as opposed to their entire wealth, they spend less to protect their positions.” *Id.* at 95.

24. EASTERBROOK & FISCHEL, *supra* note 7, at 42.

25. *Id.*

26. *Id.*

27. Easterbrook & Fischel, *supra* note 8, at 95.

28. EASTERBROOK & FISCHEL, *supra* note 7, at 42.

29. *Id.*

30. *Id.*

31. See Easterbrook & Fischel, *supra* note 8, at 95.

32. *Id.*

potential that the agent will lose his job provides him with an incentive to operate efficiently to keep share prices high.³³ By contrast, under an unlimited liability system, shares would not be fungible because “[t]heir value would be a function of the present value of future cash flows and of the wealth of [the other] shareholders.”³⁴ Under such a system, a person wishing to acquire a controlling number of shares would perhaps have to negotiate with each individual shareholder, probably paying different prices and perhaps a surcharge.³⁵ Therefore, investors would be less likely to attempt to gain control, and managers would have less fear of losing their jobs.³⁶

Finally, limited liability promotes market efficiency.³⁷ When all shares trade on the same terms, “investors trade until the price of shares reflects the available information about a firm’s prospects. . . . [I]nvestors . . . can accept the market price as given and purchase at a ‘fair’ price.”³⁸ As previously stated, if unlimited liability were the rule, shares would not be fungible, and therefore, the shares of a single company would not have one market price.³⁹ Thus, investors would be forced to expend greater resources researching the prospects of the firm to determine the right price.⁴⁰

These advantages of limited liability suggest that firms would attempt to invent limited liability if it did not exist.⁴¹ Firms would create limited liability by contract; since “[n]onrecourse lenders are limited to the assets securing the loan, just as lenders to corporations are limited to the corporate assets,” lenders would advance nonrecourse credit to firms in exchange for higher interest rates.⁴² In essence, firms would purchase “failure insurance.” Firms would buy⁴³ this insurance from the creditors since creditors have a comparative advantage in assessing the risk involved in a given transaction and monitoring the conduct of the firm during the agreement.⁴⁴ This arrangement is essentially what is observed with limited liability:

33. *Id.*

34. EASTERBROOK & FISCHEL, *supra* note 7, at 42. Under a limited liability system, “the value of shares is set by the present value of the income generated by a firm’s assets.” *Id.* In other words, shares of a firm trade at one price, and the identity and wealth of other investors is irrelevant. *Id.*; see Easterbrook & Fischel, *supra* note 8, at 96.

35. *Id.*

36. *See id.* at 43.

37. *Id.*

38. Easterbrook & Fischel, *supra* note 8, at 96.

39. *Id.*

40. *Id.*

41. EASTERBROOK & FISCHEL, *supra* note 7, at 41.

42. *Id.*

43. Firms would “buy” the insurance in the form of paying higher interest rates to their creditors. *Id.* at 48.

44. *Id.*

"[t]he creditors assume some risks of business failure, just as they would if they were 'insurers'" in addition to being creditors.⁴⁵ "The legal rule of limited liability is a shortcut to this position, avoiding the costs of separate transactions."⁴⁶

In sum, limited liability does not eliminate the risk of business failure, but rather shifts some of the risk of business failure to creditors.⁴⁷ In so doing, the risk of an enterprise is allocated to the more efficient risk-bearer.⁴⁸ If a creditor were permitted to reach an investor's personal assets after a business failure, investors would be deterred from investing.⁴⁹ Limited liability, therefore, encourages investments.⁵⁰ The creditors of limited liability companies accept additional risk,⁵¹ and therefore raise their prices to reflect the risk they have assumed.⁵² The shift in liability from shareholders to creditors produces gains for society because "the creditors are more efficient in evaluating . . . [and] bearing particular risks."⁵³

B. Piercing the Corporate Veil

Even in jurisdictions where this "first principle"⁵⁴ of corporate law has been codified, there are exceptions to the general rule of no liability for shareholders for corporate debt.⁵⁵ In other words, limited liability is not an absolute protection. One exception to the general rule of limited liability is the piercing the veil doctrine, which is a rule "to fasten liability to shareholders of corporations . . . for corporate debts of all kinds."⁵⁶ Piercing the corporate veil, then, is one example of when the separateness of the corporation will not be respected. The purpose of piercing the corporate veil is "to decreas[e]

45. *Id.*

46. *Id.*

47. *Id.* at 49–50. The economic problem can be succinctly stated: "[I]s it better to allow losses to lie where they fall or to shift those losses to some other risk bearer?" *Id.* "The market's answer [via limited liability] is partial risk shifting." *Id.* While "[e]quity investors bear more risk than debt investors, . . . debt investors continue to bear substantial risk, and the risk of all investors is limited to the amount they contribute at the outset." *Id.* If greater risk shifting were beneficial, it would have evolved in the market. *Id.*

48. Thompson, *supra* note 2, at 1039.

49. *Id.*

50. G. Michael Epperson & Joan M. Canny, *The Capital Shareholder's Ultimate Calamity: Pierced Corporate Veils and Shareholder Liability in the District of Columbia, Maryland, and Virginia*, 37 CATH. U. L. REV. 605, 606 (1988); *id.*

51. Compare to a creditor of an "identically funded enterprise where the creditors can pursue" the personal assets of the investors. Thompson, *supra* note 2, at 1039.

52. *Id.* at 1039–40.

53. *Id.* at 1040.

54. Limited liability for shareholders. PRESSER, *supra* note 3, § 1:1.

55. *Id.*

56. *Id.*

the incentive created by limited liability to engage in overly risky activities."⁵⁷

In the United States, the circumstances under which it is deemed appropriate to pierce the corporate veil are determined according to state law.⁵⁸ In general, the "veil" of the "corporate fiction" is pierced "when a court determines that the debt in question is not really a debt of the corporation, but . . . in fairness ought to be viewed as a debt of the individual or corporate shareholders."⁵⁹ An often quoted rule is stated in *United States v. Milwaukee Refrigerator*:

[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.⁶⁰

The rationales for piercing have been described as "vague and illusory."⁶¹ Two noted commentators, in one of the most often cited attempts to give some structure to the doctrine, concede that the law of veil piercing is "[l]ike lightning . . . rare, severe, and unprincipled. There is a consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law."⁶² Despite the fact that piercing seems to happen "freakishly," these two commentators suggest that the doctrine, and application of it by the courts, makes more sense than seems at first glance.⁶³

The cases may be understood, at least roughly, as attempts to balance the benefits of limited liability against its costs. Courts are more likely to allow creditors to reach the assets of shareholders where limited liability provides minimal gains from improved liquidity and diversification, while creating a high probability that a firm will engage in socially excessive level of risk taking.⁶⁴

Despite the ambiguity surrounding the application of the piercing doctrine, several factors consistently influence decisions where courts allow piercing of the corporate veil. The first factor is

57. EASTERBROOK & FISCHER, *supra* note 7, at 60.

58. Jay A. McKendree, Note, *Appropriate Federal Rules of Veil Piercing in Response to U.S. v. Cordous Chem. Co.*, 23 U. DAYTON L. REV. 419, 434 (1998).

59. PRESSER, *supra* note 3, § 1:1.

60. *U.S. v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (C.C.E.D. Wis. 1905); see PRESSER, *supra* note 3, § 1:1.

61. PRESSER, *supra* note 3, § 1:1.

62. Easterbrook & Fischel, *supra* note 8, at 89; see PRESSER, *supra* note 3, § 1:1. Professor Presser says in his treatise that "the doctrine is never likely to be pinned down to rigged particulars, and that it will evolve and change as long as our conception of . . . the corporation remain[s] changing." *Id.* § 1:2.

63. Easterbrook & Fischel, *supra* note 8, at 109 (stating that like lightning, veil piercing is "rare, severe, and unprincipled").

64. *Id.*

“whether the [firm] followed formalities and kept adequate records of its business.”⁶⁵ The idea behind this consideration is that record-keeping formalities shed light on how shareholders conducted the corporation at the time the cause of action arose.⁶⁶ The second factor that often influences a court’s decision is whether the corporation was undercapitalized—which makes piercing of the veil more likely.⁶⁷ The third factor that courts consider is whether an entity treats another entity’s assets as its own.⁶⁸ This involves inquiring into whether shareholders controlled and dominated the company.⁶⁹ Evidence of commingling of funds or assets is often strong evidence showing that a shareholder dominated the corporate entity.⁷⁰ Finally, courts inquire into whether the corporate form is used for illegitimate purposes—for example, when the corporation is used to perpetrate a fraud—or if failure to pierce would create an injustice.⁷¹ Allegations that the corporate entity is being used to perpetuate a fraud most commonly arise in contract cases where representations were made concerning the entity’s financial status, relating to the entity’s performance, or indicating that someone besides the entity would stand behind the debt.⁷² Allegations that the failure to pierce would result in an injustice normally arise in the context of tort claims.⁷³

Judge Easterbrook notes that virtually every case in which a court has pierced the corporate veil involved a close corporation.⁷⁴ This is supported by economic logic because limited liability does not reduce monitoring costs in close corporations,⁷⁵ and the incentive for managers to undertake overly risky projects is much more severe in close corporations.⁷⁶ The other major category of veil piercing cases involves parent-subsidiary combinations, where piercing the veil is also supported by economic principles.⁷⁷ “Allowing creditors to reach the assets of parent corporations does not create unlimited liability for any people . . . [so] the benefits of diversification, liquidity, and monitoring by the capital market are unaffected.”⁷⁸ Finally, courts

65. Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95, 112–13 (2001); see Epperson, *supra* note 50, at 612.

66. Huss, *supra* note 65, at 113.

67. *Id.* at 114; see Epperson, *supra* note 50, at 613.

68. Huss, *supra* note 65, at 115.

69. *Id.*

70. *Id.*

71. *Id.* at 112.

72. *Id.*

73. *Id.*

74. Easterbrook & Fischel, *supra* note 8, at 109.

75. Investors in a close corporation are typically involved in managing the corporation.

76. Easterbrook & Fischel, *supra* note 8, at 110.

77. *Id.* at 110–11.

78. *Id.* at 111.

seem to be more willing to pierce the corporate veil when the enterprise is undercapitalized.⁷⁹ Again, this makes economic sense, since “the lower the amount of [a] firm’s capital, the greater the incentive to engage in [overly] risky activities.”⁸⁰ Further, “[a]llowing creditors to look beyond the assets of the undercapitalized corporate debtor provides the debtor with the incentive to disclose its situation at the time of the transaction.”⁸¹

III. CHINA: ITS POLITICS, ECONOMY, AND COMPANY LAW

A. *China’s Economy*

The Communist Party, led by Chairman Mao Zedong, declared the formation of the People’s Republic of China following the 1949 Revolution.⁸² The Communist Party abolished free markets, nationalized most private companies into state enterprises, and implemented a centrally controlled economic system.⁸³ Holding a deep distrust of capitalism and western investors, the Party believed that a planned economy would better maximize efficiency and productivity.⁸⁴ Every aspect of the economy was planned, and the government engaged in both micro and macro economic planning.⁸⁵ A

79. *Id.* at 113.

80. *Id.*

81. *Id.*

82. Leontine D. Chuang, Comment, *Investing in China’s Telecommunications Market: Reflections on the Rule of Law and Foreign Investment in China*, 20 NW. J. INT’L L. & BUS. 509, 509 (2000); William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China’s Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT’L L. 477, 477 (2002).

83. Friedman, *supra* note 82, at 477. Specifically, Mao brought banks and the entire lending sector under direct control of the central government. Christopher M. Vaughn, *Venture Capital in China: Developing a Regulatory Framework*, 16 COLUM. J. ASIAN L. 227, 232 (2002). He abolished China’s securities markets and eradicated the wealthy lending class. *Id.*

84. K. Matthew Wong, *Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform*, 65 FORDHAM L. REV. 1221 (1996). This followed the beliefs of Lenin, who held that competition was irrelevant to the economic reality and also inherently condemned by enshrined communist ideology. Youngjin Jung & Qian Hao, *The New Economic Constitution in China: A Third Way for Competition Regime?*, 24 NW. J. INT’L L. & BUS. 107, 111 (2003). “The Chinese Marxists theorized that . . . [a] planned economy would result in maximum productivity and efficiency, since the entire population would be employed . . .” Friedman, *supra* note 82, at 477.

85. Anna M. Han, *China’s Company Law: Practicing Capitalism in a Transitional Economy*, 5 PAC. RIM L. & POL’Y J. 457, 462 (1996). Macro planning included prioritizing industries which would receive materials and funds first. *Id.* at 462–63. Micro planning included the management of every aspect of economic operation, including purchasing, production, quality control, and labor practices. *Id.* at 463.

system of government control over everything, from the purchasing of raw materials to the sale of goods, was implemented in state-owned enterprises and collectively owned enterprises.⁸⁶ More specifically, China engaged in “directive planning,” where production units were given specific targets to meet.⁸⁷ Under this arrangement, the power over the enterprises resided with various administrative organs and the bureaucrats who worked for them.⁸⁸

This economic system resulted in numerous problems. First, “[e]nterprises lacked the most basic decision making powers” because all decisions were determined by the government’s plan, as interpreted by layers of bureaucracy.⁸⁹ Second, the centralized system provided no incentive for enterprises to be innovative and profitable.⁹⁰ “[P]rofits were irrelevant since excess earnings were turned over to the government.”⁹¹ “The net effect of this system was to encourage, across the economy as a whole, complacency and resignation to the point of stagnation.”⁹²

China emerged from its self-imposed economic isolation in 1978 when the Eleventh Central Committee of the Communist Party of China adopted “a policy of economic reform and opened China to increased contacts with the outside world.”⁹³ At that time, China made a historic decision “to convert its planned socialist/communist economic system to a ‘socialist economic structure with Chinese characteristics.’”⁹⁴ The new policy “center[ed] on economic reforms [by] utilizing market mechanisms and foreign resources to speed [China’s] economic growth and modernization.”⁹⁵ The economic reforms centered around three main objectives: “(1) decentral[izing] the economy, (2) bolster[ing] reliance on market forces and . . . incentives as a means of achieving [productive] economic behavior and [efficient] resource allocation, and (3) encourag[ing] foreign investment.”⁹⁶ “The essential aim [of the reforms] was the devolution of economic decision making power from higher to lower level governmental bodies and, in a few cases, the transfer of power

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.* at 463–64.

90. *Id.* at 464.

91. *Id.*

92. *Id.*

93. Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 65 (1993). Commentators often refer to this as “the sleeping giant awakening.” *Id.*

94. Han, *supra* note 85, at 458.

95. Friedman, *supra* note 82, at 478.

96. Ann P. Vandavelde, *Realizing the Re-Emergence of the Chinese Stock Market: Fact or Fiction?*, 30 VAND. J. TRANSNAT’L L. 579, 584 (1997).

out of the bureaucratic hierarchy altogether and into the private sector.”⁹⁷

Since adopting this open door policy, China has experienced rapid economic growth.⁹⁸ Its economic growth and modernization began with the enactment of laws permitting foreign investment in China in the form of joint ventures.⁹⁹ In 1982, China revamped its constitution to recognize the rights of individual businesses and private enterprise, though these rights were not clearly articulated.¹⁰⁰ Then in 1990, China established two national securities exchanges to centralize and control its securities markets.¹⁰¹ In 1992, the China Securities Regulatory Commission (CSRC) was created as the national regulatory body of the securities

97. Wong, *supra* note 84, at 1226–27 (citing Donald C. Clarke, *What's Law Got To Do With It? Legal Institutions and Economic Reform in China*, 10 UCLA PAC. BASIN L.J.1, 3 (1991)). The Communist Party embarked on a strategy of corporatization and securitization, with only limited privatization. Friedman, *supra* note 82, at 478. Corporatization means the “conversion of state-owned enterprises into shareholding companies,” and securitization means the “sale of shares of state-owned enterprises in the securities market.” *Id.* Limited privatization refers to “minority private equity participation in state-owned enterprises so as to enable the government to retain majority control of the market.” *Id.* The effect, then, was that the market would continue to be susceptible to governmental control, while the private sector would be encouraged to invest. *Id.*

98. Kenneth Lieberthal & Geoffrey Lieberthal, *The Great Transition*, 2003 HARV. BUS. REV. 70, 72 (2003) (stating that China’s annual real GDP has grown about 9% a year, on average, since 1978.) Further, foreign trade has grown, on average, by 15% a year, or more than 2,700% in aggregate. *Id.* “In 2002, China became the first country [in nearly two decades] to attract more FDI in a year than the United States.” *Id.* Another interesting fact demonstrating China’s economic progress: “four to six million new cell phone subscribers are signing up every month.” *Id.*

99. The substantive reforms began with the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures (JVL), which was the Chinese government’s first statute governing foreign investment. Chuang, *supra* note 82, at 511–12. The purpose of the JVL was to allow foreign companies to join Chinese companies in establishing joint ventures that were in accordance with the principles of equality and mutual benefit. *Id.* at 512. Joint ventures had to be approved by the Chinese government, and it was understood that China did not plan to open its entire economy to foreign investment. *Id.* at 511–12. Further reforms included amendments to its constitution in 1982 which explicitly protected foreign investors “lawful rights and interest in the People’s Republic of China.” *Id.* at 512.

100. Michael Irl Nikkel, “*Chinese Characteristics*” in *Corporate Clothing: Questions of Fiduciary Duty in China’s Company Law*, 80 MINN. L. REV. 503, 508 (1995). Nevertheless, these new provisions in the constitution “laid the foundation for China’s new conception of private ownership.” *Id.* at 509.

101. Friedman, *supra* note 82, at 486; Jay Zhe Zhang, *Comment: Securities Markets and Securities Regulation in China*, 22 N.C. J. INT’L L. & COM. REG. 557, 559 (1997); The Shanghai Stock exchange and the Shenzhen Stock Exchange were established within six months of each other. Wong, *supra* note 84, at 1222. Similar to the New York Stock Exchange, these stock exchanges were meant to ensure the maintenance of a fair and orderly marketplace. Friedman, *supra* note 82, at 487. Initially, the two exchanges were regulated by local regulations that were slightly different from each other—there was no uniform set of regulations. *Id.* at 486.

market.¹⁰² However, perhaps the most significant development in this continuing series of economic legislation and reforms was the promulgation of the Company Law.¹⁰³

B. *The Company Law*

Prior to 1994, China lacked a national, uniform legal framework “that clearly established the rights and responsibilities of the shareholders” and managers of companies.¹⁰⁴ This changed with the adoption of the Company Law.¹⁰⁵ The Company Law is recognized as a key element in the process of economic reform that began in 1978.¹⁰⁶ Its adoption of the concept of limited liability indicates that the Chinese government recognizes the benefits of limited liability in encouraging capital formation and entrepreneurship.¹⁰⁷ The law serves four primary purposes: “(1) to restructure the organization and management of state-owned enterprises; (2) to address . . . problems of inefficiency; (3) to promote competition and productivity; and (4) to remove the state from detailed management of business operations.”¹⁰⁸ In short, it was enacted to help transform China’s socialist, planned economy “into a market-oriented system by shifting the control of business organizations from government to private citizens.”¹⁰⁹ It provides a legal framework for the protection of both foreign and domestic investors.¹¹⁰ It “standardize[s] the organization

102. Zhang, *supra* note 101, at 563. The CSRC eventually promulgated comprehensive rules governing the exchanges. *Id.* For example, the rules defined securities exchanges as non-profit organizations with a “legal person” status. *Id.* at 564. The rules mandated that the exchanges be governed by a board of directors, with half the directors being elected by members of the exchange and the other half appointed by the government. *Id.* The government’s control over the securities market greatly increased with the new rules. *Id.* at 565. The CSRC was granted even more control over the exchanges. *Id.* The CSRC nominated the chairman and vice-chairman of the board of directors, and the general manager and deputy general manager of each exchange. *Id.* Further, the rules and procedures for the operations of the exchanges had to be approved by the CSRC. *Id.* In effect, the CSRC was given the power to exercise control over the daily operations of the exchanges. *Id.*

103. Han, *supra* note 85, at 459. The Securities Law, enacted in 1999, is the other major piece of legislation of particular significance.

104. Wong, *supra* note 84, at 1232.

105. *Id.* See The Company Law, *supra* note 5. The Law became effective on July 1, 1994. Wong, *supra* note 84, at 1232.

106. Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People’s Republic of China*, 20 YALE J. INT’L L. 273, 274 (1995).

107. Chuan Roger Peng, *Limited Liability in China: A Partial Reading of China’s Company Law of 1994*, 10 COLUM. J. ASIAN L. 263, 279–80 (1994).

108. Art & Gu, *supra* note 106, at 274–75.

109. Anyuan Yuan, *Foreign Direct Investments in China: Practical Problems of Complying with China’s Company Law and Laws for Foreign-Invested Enterprises*, 20 NW. J. INT’L L. & BUS. 475, 476 (2000).

110. Nikkel, *supra* note 100, at 522. At least one of the “purposes of the Company Law is to reform existing state enterprises and to allow foreign investment in

and conduct of companies [and] protect[s] the legitimate interests of . . . shareholders and creditors.”¹¹¹ Perhaps most significantly, it expressly recognizes the legality of limited liability forms of business organizations.¹¹²

Six aspects of the Company Law are worthy of discussion, as they impact the later discussion of the veil piercing doctrine in China. First, while modeled on Western corporation codes, the Law has distinctly Chinese characteristics. Second, the Law recognizes limited liability with respect to two corporate forms and requires corporations to have a legal representative who can be held liable in certain circumstances. Third, the stringent requirements for incorporation mean that the government retains considerable control over who is permitted to incorporate.¹¹³ Fourth, a joint stock corporation¹¹⁴ must set up a supervisory committee comprised of shareholders and employees.¹¹⁵ Fifth, shareholders are well favored under the Company Law—at least relative to shareholders in U.S. corporations—in that they are given a considerable amount of power over the management of the company. Sixth, the Law places restrictions on distributions to shareholders.

While the distinct mission of the Company Law is to “meld the organizational structure of Western capitalist business into a political and economic regime that maintains socialist principles and goals,”¹¹⁶ the law is modeled in significant part on U.S. and other Western corporation codes.¹¹⁷ For example, like most Western legal regimes, the Company Law provides shareholders with limited liability, preemptive rights, and the power to elect directors.¹¹⁸ The Law also permits the issuance of dividends¹¹⁹ and imposes fiduciary duties on directors.¹²⁰ However, despite the presence of these Western

these enterprises,” but the law also reflects China’s desire to develop its “domestic underwriting industry and to prevent [] international securities firms from monopolizing the underwriting process.” Wong, *supra* note 84, at 1232.

111. Yuan, *supra* note 109, at 476.

112. See Peng, *supra* note 107, at 266.

113. See generally Wong, *supra* note 84 (describing the history of the Company Law and its requirements); Yuan, *supra* note 109 (describing the process of incorporation).

114. A joint stock corporation is also known as a “corporation limited by shares.” Wong, *supra* note 84, at 1233 n.79.

115. In theory, the supervisory committee stands as an impediment to management doing whatever it wants. However, it is not clear how much this requirement really impinges on management’s ability to act. The Company Law does not further define the powers that the supervisory committee retains. See Yuan, *supra* note 109, at 488–89.

116. Art & Gu, *supra* note 106, at 273–74.

117. *Id.* at 274.

118. See The Company Law, *supra* note 5, at arts. 3, 38.

119. See *id.* at art. 35.

120. See *id.* at art. 123; see generally Nikkel, *supra* note 100 (discussing questions of fiduciary duty in the Company Law).

properties, the Law is distinctly Chinese in its attempt to meld these Western ideas into the Chinese goal of promoting a socialist market economy.¹²¹ Western corporation codes are designed “to reduce transaction costs by implying in every corporate charter the normal rights that a shareholder could be expected to insist on, of which the most important is the right to cast votes, equal to the number of shares he holds, for membership on the corporate board of directors.”¹²² This standardization of basic rights ensures that investors will find it unnecessary to investigate what their rights will be in every corporation.¹²³ As discussed above, this enables investors to efficiently “reallocate their capital based more on the economic value of the firm” rather than the bargain with management or other investors.¹²⁴ In turn, stocks become a more fungible commodity.¹²⁵

In contrast, the Company Law was designed more as a management tool.¹²⁶ The goal of the Company Law is not privatization but corporatization.¹²⁷ Corporatization involves “restructuring state enterprises, adopting the corporate form, and instituting stock ownership and trading without necessarily relinquishing the state’s controlling interest.”¹²⁸ Therefore, the Chinese government often maintains a majority ownership interest in state enterprises that it converts into the corporate form.¹²⁹

The concept of limited liability is applicable to corporations governed by the Company Law.¹³⁰ The law creates two classes of

121. Art, *supra* note 106, at 275.

122. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 452 (6th ed. 2003).

123. WILLIAM B. GAMBLE, *INVESTING IN CHINA: LEGAL, FINANCIAL, AND REGULATORY RISK* 150 (2002).

124. *Id.*

125. *Id.*

126. *Id.*

127. Vandeveld, *supra* note 96, at 587. The fact that China is not seeking privatization is reflected in Article 1 of the Company Law, which states as one of the law’s purposes the maintenance of “the socialist economic order” and the promotion of “the development of the socialist market economy.” The Company Law, *supra* note 5, at art. 1. The Law regards corporations as “a necessary evil to be closely regulated rather than an economic engine to be encouraged and released.” Art & Gu, *supra* note 106, at 289.

128. Art, *supra* note 106, at 283.

129. *Id.*

130. The Company Law, *supra* note 5, at art. 3.

A company is an enterprise juridical person, which has independent juridical person property and enjoys the property right of the juridical person. And it shall bear the liabilities for its debts with all its property. As for a limited liability company, the shareholders shall be responsible for the company to the extent of the capital contributions they have paid. As for a joint stock limited company, the shareholders shall be responsible for the company to the extent of the shares they have subscribed to.

stock companies: the limited liability company¹³¹ and a company limited by shares¹³² (also known as a joint stock company).¹³³ The limited liability company form is used by smaller corporations, which are analogous to closely held corporations in the United States.¹³⁴ The shares of limited liability companies are not freely transferable, so these companies do not participate in China's securities markets.¹³⁵ A joint stock company is the company form used for larger companies which are permitted to issue shares to the public.¹³⁶ Joint stock companies are governed by shareholders, a board of directors, a supervisory board, and the executive management—similar to the governance structure of companies limited by shares.¹³⁷ “[T]here is no nationality requirement for the shareholder of a joint stock company,” which reflects China's desire to attract foreign capital and the reality that there was already a sizeable foreign participation in the stock market before the Company Law was promulgated.¹³⁸ However, there are some restrictions on foreign nationals. For example, they are not permitted “to purchase ‘A shares,’ which are common stocks issued [only] to Chinese residents for domestic trading only.”¹³⁹

Instead of setting up a corporation as a virtual person, the Company Law requires each corporation to have a “legal representative.”¹⁴⁰ Similar to an agent in U.S. corporate law, the legal representative is the person authorized to act on behalf of the company and to bind the company in a given matter.¹⁴¹ The legal representative is the Chairman of the Board of Directors or Chief

131. The Chinese term for limited liability company is You Xian Ze Ren Gong Si. Art, *supra* note 106, at 291.

132. The Chinese term for a company limited by shares is his Gu Feng You Xian Gong Si. *Id.*

133. Zhang, *supra* note 101, at 566.

134. Five of the main requirements to establish a limited liability company are: (1) the limited liability company must not have more than fifty shareholders, (2) the shareholders shall invest through capital contributions, (3) the articles of association must be worked out jointly by the shareholders, (4) the company must have a domicile, and (5) the name and organizational structure of the company complies with the Company Law. The Company Law, *supra* note 5, at arts. 23, 24A.

135. Zhang, *supra* note 101, at 566–67.

136. *Id.* at 567. The requirements to establish a joint stock company are as follows: (1) the company must have at least two but no more than two hundred initiators; (2) the initiators must be able to raise the statutory minimum amount of capital; (3) the issuance of shares must conform with the law; (4) the initiators must formulate the articles of association, which are adopted at the establishment meeting; (5) the name and organizational structure of the company conforms with the law; and (6) the company has a domicile. The Company Law, *supra* note 5, at art. 77.

137. Zhang, *supra* note 101, at 567; see The Company Law, *supra* note 5, at arts. 102–28.

138. Wong, *supra* note 84, at 1233.

139. *Id.*

140. GAMBLE, *supra* note 123, at 152.

141. Art, *supra* note 106, at 294.

Executive Officer, and he or she is subject to sanctions for the corporation's misconduct.¹⁴² Importantly, the concept of a legal representative is an encroachment on limited liability.¹⁴³ Although the representative is not personally liable for corporate debts, he or she may be fined, subjected to administrative sanctions, or even prosecuted if the corporation commits a crime.¹⁴⁴ One author succinctly summed up the significance of the legal representative: "To protect itself and its property, the government was willing to adopt the concept of limited liability. However, when it put its property in the hands of a steward, it wanted to be able to hold the steward personally to account."¹⁴⁵

While not arduous, the process of incorporation under the Company Law is fairly stringent, relative to that of U.S. jurisdictions.¹⁴⁶ This seems to serve one main purpose: to minimize opportunities for fraud and abuse.¹⁴⁷ Such fears are not as readily apparent in more advanced economies because businesses and individuals are accustomed to protecting themselves.¹⁴⁸ The same cannot be said of newly incorporated Chinese companies and their investors. Therefore, by maintaining strict standards on who can exercise the privilege of incorporating, the Chinese government may be able to prevent, or at least reduce, instances of the use of the corporate form for fraudulent purposes.

The Company Law also requires a joint stock company to set up a supervisory committee—a requirement borrowed from the German corporate code.¹⁴⁹ The committee must be comprised of at least three persons and can include only shareholders and employees.¹⁵⁰ The supervisory committee is supposed to act as a watchdog over the board of directors, but the committee does not have extensive powers.¹⁵¹ Article 120 of the Company Law states that the committee

142. *Id.*

143. *Id.*

144. *Id.*

145. GAMBLE, *supra* note 123, at 152.

146. *See* The Company Law, *supra* note 5, at arts. 77–93.

147. Art. *supra* note 106, at 289.

148. *Id.* at 289, n.102.

149. The Company Law, *supra* note 5, at art. 118 (stating that a "joint stock company shall set up a board of supervisors"); Yuan, *supra* note 109, at 488. Limited liability companies are permitted to have supervisory committees, but they are not required. The Company Law, *supra* note 5, at art. 52 (stating that a "limited liability company may set up a board of supervisors").

150. The Company Law, *supra* note 5, at art. 118. The percentage of the representatives of the employees can account for no less than one third of all the supervisors. *Id.* The employee representatives are democratically elected through the meeting of representatives, shareholders' meeting, or by other means. *Id.*

151. GAMBLE, *supra* note 123, at 152.

must keep a record of its decisions, but no part of the law actually says what types of decisions the committee should be making.¹⁵²

In the United States and most other Western jurisdictions, the powers of the corporation are vested in the board of directors.¹⁵³ By contrast, the Chinese Company Law says that "the shareholders' meeting¹⁵⁴ of a limited liability company shall . . . be the authority of the company."¹⁵⁵ Likewise, with respect to joint stock companies, the Company Law says that "the shareholders' meeting . . . is the company's organ of power."¹⁵⁶

The specific powers granted to the shareholders' meeting are the same for limited liability companies and joint stock companies.¹⁵⁷ Some of the powers are no different than what one would expect to find in any Western corporation code. For example, the shareholders have the power to elect directors and revise the articles of incorporation.¹⁵⁸ However, the Company Law also gives shareholders additional powers that are atypical of those found in Western corporation codes. They have the authority to: determine the company's operation guidelines and investment plans; deliberate and approve annual financial budget plans and final account plans of the company; make resolutions on the increase or decrease of the company's registered capital; make resolutions on the issuance of corporate bonds; and adopt resolutions on the assignment, split-up, change of company form, dissolution, and liquidation of the company.¹⁵⁹ In sum, the shareholders are given considerable authority over the management of the company.¹⁶⁰ This list of powers demonstrates that shareholders can decide on policies regarding business operations, determine investment plans, and examine and approve plans for the company's profit distribution and strategy to deal with losses.¹⁶¹

Further, shareholders are permitted to exercise their powers more than once a year. Article 40 permits regular meetings and

152. The Company Law, *supra* note 5, at art. 120; *see generally* The Company Law, *supra* note 5.

153. GAMBLE, *supra* note 123, at 152.

154. A shareholders' meeting for both limited liability companies and joint stock companies comprises all the shareholders. The Company Law, *supra* note 5, at arts. 37, 99.

155. *Id.* at art. 37.

156. *Id.* at art. 99.

157. *Id.* at art. 100 ("The provisions regarding the authorities of the shareholders' meeting of a limited liability company as prescribed in the first paragraph of Article 38 of this law shall apply to the shareholders' meeting of a joint stock company.").

158. *Id.* at art. 38.

159. *Id.*

160. GAMBLE, *supra* note 123, at 153.

161. The Company Law, *supra* note 5, at art. 38; *see* GAMBLE, *supra* note 123, at 153.

temporary meetings.¹⁶² While regular meetings are held pursuant to the Articles of Association, temporary meetings can be held whenever shareholders representing 10% or more of the voting rights propose such a meeting.¹⁶³

The amount of authority delegated to shareholders is not surprising considering that the Chinese government is the largest shareholder in most of the largest enterprises.¹⁶⁴ By delegating such authority to the shareholders, the government can still manage a corporation de facto.

“Another unique provision of the Company Law [requires corporations to] set aside a portion of [their] profits in a reserve fund until the fund equals [50%] of the company’s capital.”¹⁶⁵ This paternalistic restriction is designed to protect China’s inexperienced shareholders—a category into which most Chinese shareholders fall.¹⁶⁶ While the requirement perhaps stabilizes dividends and reduces the chance of bankruptcy, it also reduces management’s ability to reinvest profits and infringes on management’s right to deploy financial resources.¹⁶⁷ The reserve fund requirement has a particularly strong effect on converted state enterprises—state enterprises generally have a large capital base, but the reserve fund requirement prevents these converted companies from paying out significant dividends, at least for the first few years.¹⁶⁸

C. Piercing the Veil in China

The Company Law did not recognize the doctrine of piercing the corporate veil when it was enacted in 1994. Nor was the doctrine recognized in the 1999 or 2004 amendments to the Law. However, corporate veil piercing was finally recognized in the most recent amendment to the Company Law, which became effective in 2006.¹⁶⁹

The 2006 amendment did not introduce an entirely foreign concept into Chinese law; Chinese courts had pierced the corporate veil prior to 2006. Prior to the latest version of the Company Law, the primary authority for piercing the corporate veil in China was found in a 1994 Chinese Supreme Court document responding to a question presented by the Higher People’s Court of Guangdong.¹⁷⁰ The

162. The Company Law, *supra* note 5, at art. 40.

163. *Id.* at arts. 40, 101.

164. See GAMBLE, *supra* note 123, at 153 (stating that the government is the majority shareholder of virtually all companies listed on the Shanghai Stock Exchange).

165. Wong, *supra* note 84, at 1234.

166. *Id.*

167. *Id.*

168. *Id.*

169. See The Company Law, *supra* note 5.

170. Albert, *supra* note 8, at 882.

document discussed a situation in which one enterprise established a company, and the established company eventually went out of business.¹⁷¹ The Chinese Supreme Court stated in the document that if the assets of the bankrupt company are not sufficient to satisfy the debts, “then the enterprise that established the company will assume civil liability to the extent that the amount of registered capital of [the bankrupt] company exceeds the actual capital contribution made to it.”¹⁷² In addition, if no capital was contributed to the bankrupt company, “or the amount was not sufficient according to law, then the [establishing] company” would assume the full civil liability of the bankrupt company.¹⁷³

The main criticism of the document is that the situation it contemplates is too narrowly tailored.¹⁷⁴ It seemingly permits veil piercing only in limited circumstances involving undercapitalization or improper registration.¹⁷⁵ Further, it fails to provide any guidance for cases in which the piercing doctrine might be applied to other abuses of the corporate entity.¹⁷⁶

Chinese court opinions show that courts were willing to pierce the corporate veil but only in the most limited circumstances, and the doctrine was inconsistently applied.¹⁷⁷ For example, in one case, the Chinese Supreme Court affirmed a lower court’s “decision to pierce [a corporation’s] veil . . . when it was [discovered] that the company was really an instrument of the government and did not have any invested capital.”¹⁷⁸ In another case, the Chinese Supreme Court found that a state-owned enterprise, which was a minority shareholder in a company, was liable for the debts of the company because the state-owned enterprise was “liable for the wrongdoing and had made no capital contribution.”¹⁷⁹

171. *Id.* at 883.

172. *Id.*

173. *Id.* In addition, if “the facts show that a company did not meet the [requisite] conditions for registration as a legal person,” the document states that the People’s Court may choose to disregard the legal person status of the enterprise. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.* at 884.

178. *Id.* at 885 (“In addition, the court found that the assets of this company were moved to another company (established by the same government office) just before a judgment on behalf of the creditor was to be executed.”).

179. *Id.* Another case is also noteworthy. In *Rosin Factory of Wuzhou v. Huajian*, “the court found that the defendant company was nothing more than ‘a shell company with no capital, no site for operations and no ability to perform contracts’ and that it did not meet the conditions for a limited liability company.” *Id.* The court held the company is “liable for the amount owed to the plaintiff.” *Id.* at 886. However, the company’s investor and legal representative were nowhere to be found, so the court placed liability on the commission which improperly verified the information on the defendant’s business application. *Id.*

Therefore, the doctrine of veil piercing was utilized, albeit in the narrowest of circumstances. Several factors stood in the way of the doctrine's proper usage. The interference of local Communist Party branches slowed proceedings and made the collection of evidence difficult, inexperienced judges did not know how to apply the doctrine, and the tendency to protect local companies mitigated efforts to utilize the doctrine.¹⁸⁰ Also, the inability of judges to enforce their decisions weakened the judiciary as a whole.¹⁸¹ Finally, as discussed below, China's civil law system severely constricts the power of the judiciary, and therefore, only statutory recognition of the doctrine could lend the requisite credibility to make the doctrine meaningful.

The Company Law was amended for a third time and adopted at the Eighteenth Session of the Standing Committee of the Tenth National People's Congress of the People's Republic of China on October 27, 2005.¹⁸² Among other additions and revisions,¹⁸³ the amendment added a provision explicitly permitting courts to pierce the corporate veil.¹⁸⁴ The provision states:

Where any of the shareholders of a company evades the payment of its debts by abusing the independent status of juridical person or the shareholder's limited liabilities, and thus seriously damages the interests of any creditor, it shall bear joint liabilities for the debts of the company.¹⁸⁵

Codifying the corporate veil piercing doctrine is a necessary step if the doctrine is to have significance in China's corporate law. The primary reason that such prescription is necessary is that China has a civil law legal system, which means there is a pronounced bias in favor of positive, statutory law, as opposed to judicially articulated case law and jurisprudence.¹⁸⁶ Whereas in a common law legal system (such as the United States and Great Britain) the doctrine of veil piercing may be elaborated almost exclusively in court opinions,

180. *Id.*

181. *Id.* at 886–87.

182. *China's New Company Law is Coming*, PINSENT MASONS UPDATE, Nov. 2005, available at <http://www.pinsentmasons.com/media/1411543471.pdf>.

183. Among the other additions and revisions are: lower incorporation threshold; removal of the cap on outward investment; permission to form one-person limited liability companies; improved corporate governance provisions, such as new restrictions on the Chairman of the board of directors and the delegation of more power to the board of supervisors; and increased protections for shareholders, such as the right to check the company's account books and the right to have shares repurchased by the company. *Id.*

184. *Id.*

185. The Company Law, *supra* note 5, at art. 20.

186. Nicholas C. Howson, Professor, Cornell L. Sch., Regulation of Companies with Publicly Listed Share Capital in the People's Republic of China, Speech to the International Seminar on Amendment of the PRC Company Law (Oct. 10–12, 2004), in 38 CORNELL INT'L L.J. 237, 242–43 (2005).

in China the doctrine must be codified in a formal statute or regulation and then invoked by a court in arriving at a decision.¹⁸⁷

Further background on China's legal system will demonstrate the importance of statutory law. Under China's constitutional framework, the courts are "under the 'supervision'" of the legislature.¹⁸⁸ China views legislation from the central and local-level governments as well as administrative regulations as the sole sources of law, and it permits only the legislative or administrative body that promulgated a rule to interpret it.¹⁸⁹ Further, judicial decisions have no precedential value, although courts deciding later cases may use an earlier decision as a reference.¹⁹⁰

The basic power to interpret legislation is divided between the Standing Committee of the National People's Congress (NPC) and the State Council, with only limited roles assigned to the Supreme People's Court.¹⁹¹ "The People's Court has been given only the power to interpret problems of the concrete application of laws or regulations in the course of litigation;"¹⁹² it may not invalidate any laws.¹⁹³

Viewed in the abstract, codification may not be the best approach to developing a veil piercing doctrine. Professor Thompson persuasively argues that the doctrine should be left to develop at common law.¹⁹⁴ With common law, "[l]ines are drawn by judges after the fact," whereas with statutory law, the lines are drawn by

187. *Id.* at 243. Another example is the concept of fiduciary duty. *Id.*

188. STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 281 (1999); Chris X. Lin, *A Quiet Revolution: An Overview of China's Judicial Reform*, 4 *ASIAN-PAC. L. & POL'Y J.* 255, 275 (2003).

189. LUBMAN, *supra* note 188, at 282. China's adherence to this position leaves no room for courts to exercise interpretive powers. *Id.* "Economic reforms, however, are generating pressures on the courts to depart from these doctrines, and the Supreme People's Court is engaged in an effort to promote the coherence of promulgated laws and to provide guidance to a judicial hierarchy whose authority is badly splintered." *Id.* In addition, legislatures generally have very little incentive to interpret the law, so citizens are often left in a quandary with no legal recourse. Lin, *supra* note 188, at 275 ("When citizens that suffer injustice complain to the legislature, or pursuant to the Law on Legislation to the particular government agency in charge of a particular law's implementation, they will likely meet indifference and delays.").

190. LUBMAN, *supra* note 188, at 282. Chinese doctrine firmly denies any binding force to judicial decisions. *Id.* at 284. Published court opinions "may be considered instructive examples, but they are not supposed to be considered a source of law." *Id.* Nevertheless, the Supreme People's Court has been publishing selected opinions, and some scholars argue that the court intends for these publications to carry the same weight as precedent. *Id.* at 285. In addition, a "growing number" of Chinese legal scholars believe that such opinions should be treated as precedent. *Id.* The published cases will "guide the courts and create legal norms . . . thereby filling many of the gaps in Chinese Law." *Id.*

191. *Id.* at 282.

192. *Id.*

193. *Id.*

194. Thompson, *supra* note 6, at 623.

“legislators before the fact.”¹⁹⁵ Basing his argument on the U.S. approach,¹⁹⁶ Professor Thompson argues that an “internal logic” develops with both fairness and predictability as cases articulate general rules.¹⁹⁷ “[T]he common law permits the law to adapt to changes in circumstances in order to maintain the appropriate equilibrium between the law and the social norms in which it is embedded.”¹⁹⁸ The common law changes incrementally, permitting adaptation to such change without “undermining the legitimacy of the rule of law.”¹⁹⁹ In a setting where private planning is accorded a “first mover advantage,” the common law has particular advantage because “private planning will [almost] inevitably devise new schemes [to] avoid a particular legal rule.”²⁰⁰ Since judicial decisions permit the law “to continuously define the boundaries in a way that legislation [can]not,”²⁰¹ the common law is more adept at responding to such schemes.²⁰² He explains that “[t]he common law is modest in that it recognizes that not all knowledge comes at once, such that the process is necessarily experimental and a particular result may be provisional, subject to review if conflicting evidence is presented in a subsequent case.”²⁰³

However, barring momentous changes to China’s legal system, any piercing doctrine must necessarily be developed by statutory law.²⁰⁴ This is not to say, however, that codifying the doctrine will be without its advantages over a doctrine developed at common law. Some of the colorful descriptions of the common law veil piercing doctrine have already been noted.²⁰⁵ Codifying the doctrine, rather than leaving it to the courts to develop, may make it possible for

195. *Id.*

196. Professor Thompson defines the U.S. approach as “permitting private parties the first move in setting up a separate corporation and asking courts to disregard the separate entity in appropriate circumstances.” *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*; see WORMSER, *supra* note 9, at 38.

Corporate law, in particular, develops so rapidly that such a formulation would be stale even before the date of its publication. The law moves. It must be moulded [sic] carefully to meet the ever changing needs of the present hour. It must not be placed in a strait-jacket. Those who would codify it fail to understand the spirit and genius which underlie it. . . . The best way to handle the problem is through the orderly and timely development and evolution of the common law pursuant to the established judicial methods and legal processes of over a thousand years. May we be preserved from statutory interference!

Id.

203. Thompson, *supra* note 6, at 623.

204. See *supra* notes 186–93 and accompanying text.

205. See *supra* notes 1, 62.

China to avoid some of the ambiguity that has plagued the doctrine when it has been permitted to develop at common law.

The ambiguity plaguing veil piercing in common law jurisdictions centers on two areas. First, courts often “reason by pejorative.”²⁰⁶ For example, courts often justify their decision to pierce the corporate veil by saying that the corporation was a mere “sham” or “shell,” or was the defendant’s “alter ego.”²⁰⁷ To say the least, these terms are unhelpful. They describe the result (that the corporate veil is pierced), but they do little to explain the reasons for the decision.²⁰⁸ Words like sham and shell convey a lack of substance to the corporation, but to the extent that this refers to a lack of capitalization, it would be clearer to simply state that the corporation was undercapitalized.²⁰⁹ In addition, these terms often lead to a “search [of] the defendant’s purpose for establishing the corporation,” which implies that establishing a corporation in order to avoid personal liability is somehow disingenuous.²¹⁰ This cannot be correct, since most corporations only exist for the purpose of extending limited liability to the owners.²¹¹

Second, the multi-factor approach utilized by courts leads to indeterminacy.²¹² How many of the factors must be present before it is permissible to pierce? The opinions provide little guidance, and over time the list of factors tends to grow.²¹³ Invoking multiple factors, without any real guidance as to how much weight to accord each factor or the factors collectively, serves only to confuse those who look to a case for precedent.²¹⁴ Judges often resort to metaphors to aid understanding,²¹⁵ the result being that there are “hundreds of

206. Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 855 (1997).

207. *Id.*

208. Thompson, *supra* note 6, at 624.

209. Gevurtz, *supra* note 206, at 855.

210. *Id.*

211. *Id.*

212. *Id.* at 857. Several factors often cited by the courts are: undercapitalization, failure to observe corporate formalities, non-payment of dividends, use of corporate funds for personal purposes, and absence of corporate records. *Id.* at 856–57.

213. Thompson, *supra* note 6, at 624.

214. Gevurtz, *supra* note 206, at 858. Professor Thompson notes that Judge Posner has been “critical of a multi-factor judicial approach to the debt-equity distinction in tax law.” Thompson, *supra* note 6, at 624–25. Judge Posner “argued that the multi-factor approach over time is non-directive, with no indication as to how to weigh the various factors, which in turn ‘invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb.’” *Id.* at 625. *But see id.* (stating that Congress has never defined securities fraud, and instead has left it to judicial development, because a “more specific definition will provide a roadmap for fraud as planners devote their energy to schemes that are within the spirit of the law but cleverly fall outside the proscribed definition”).

215. Thompson, *supra* note 6, at 624.

decisions that are irreconcilable and not entirely comprehensible.”²¹⁶ In addition, simply listing factors and evaluating their fulfillment or lack thereof escapes any analysis based on policy or the underlying principles of the doctrine.²¹⁷ There is rarely any analysis in the decisions about why a particular factor should influence a decision about whether or not to pierce the veil.²¹⁸ Instead, there tends to be blind adherence to the idea that if a certain factor or collection of factors is present, then the corporate veil should be pierced.²¹⁹

In sum, the advantages of permitting the piercing doctrine to develop at common law are balanced against some disadvantages, though the balance may not be perfect. As another commentator noted, “A description of the various ‘rules’ relating to the doctrine of piercing the corporate veil is difficult to define because of the seemingly random manner in which courts have applied the doctrine.”²²⁰ The same commentator argues that the veil piercing doctrine has become so flawed that it is time to reconsider the use of the common law concept entirely.²²¹ She proposes that legislatures codify the best aspects of corporate veil piercing doctrine, in order to provide courts with a framework to apply the doctrine consistently.²²²

IV. REFINING CHINA’S STATUTORY VEIL PIERCING DOCTRINE

When it considered an amendment to the Company Law to add a veil piercing doctrine, the task before the NPC was to design a provision that provided courts with enough direction so that they could apply the doctrine effectively and uniformly while still leaving the courts nominal discretion so that entrepreneurs could not simply devise ways to avoid the rule.²²³ Unfortunately, the veil piercing provision in the Company Law falls short of this goal. As presently constituted, the Company Law permits veil piercing when a shareholder abuses the corporate form in order to evade the payment of debts, thereby causing damage to the interests of creditors.²²⁴ However, the provision fails to specify what conduct amounts to an

216. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* 8 (1983).

217. Gevurtz, *supra* note 206, at 857.

218. See Thompson, *supra* note 6, at 624 (“Judges find the list more available and accessible than the underlying principles.”).

219. Gevurtz, *supra* note 206, at 856.

220. Huss, *supra* note 65, at 109.

221. *Id.* at 96.

222. *Id.*

223. See *supra* note 202 and accompanying text.

224. The Company Law, *supra* note 5, at art. 20.

abuse of the corporate form.²²⁵ Indeed, the statute points to no factors that the courts should consider in their analyses. The provision is deficient because it lacks the specificity mandated by China's civil law system.

Given the limited ability of Chinese courts to interpret statutory law and the inability to develop common law, it is imperative that the Company Law be explicit about when it is appropriate to pierce the corporate veil. In other words, the NPC must provide clear standards for courts to follow in deciding whether or not to pierce. Importantly, though, the standards need not be perfectly precise: the NPC has permitted the courts to interpret laws at the margin as long as the interpretation does not amount to law-making.²²⁶

This Note advances two suggestions that would make the veil piercing provision a more effective element of China's corporate law. First, the provision should distinguish between two situations which will confront the courts: one in which piercing would result in reaching another corporation (parent-subsidary context) and one in which piercing would result in reaching an individual shareholder or shareholders (the human context).²²⁷ Second, the provision should distinguish between tort and contract creditors, as economic considerations impact how each of these creditors is viewed.

A. *Distinguishing Between the Parent-Subsidiary Context and the Human Context*

The parent-subsidiary context and the human context present unique circumstances and facts that often require a court to perform different inquiries. Empirical evidence from U.S. jurisdictions supports the statement that the two contexts should be examined

225. See *id.* at art. 20 (failing to reference what conduct constitutes an abuse of the corporate form).

226. See LUBMAN, *supra* note 188, at 282 (noting that the Court may "clarify[] and strengthen[] the laws without changing their original meaning.>").

227. Professor Thompson notes in his empirical study of veil piercing that in his data set piercing "did not occur in a publicly held corporation." Thompson, *supra* note 2, at 1047. He argues that courts refuse to pierce the veil of such corporations because the "market-related benefits of limited liability are sufficient to prevail over all possible claims of those who have claims against the public corporation and cannot collect from its assets." *Id.* at 1048. The same arguably holds true for Chinese corporations which are publicly held. Therefore, in the human shareholder context, we would expect to see piercing to occur only with respect to limited liability companies, as opposed to joint stock companies. Limited liability companies are comparable to close corporations in the United States, whereas joint stock companies are permitted to have shares that trade publicly. However, it is probably unnecessary to explicitly limit the doctrine to limited liability companies since it is unlikely that the actions of the shareholders of a joint stock company would meet the elements of the test, discussed *infra* p. 32.

differently.²²⁸ It is not surprising, then, that many U.S. jurisdictions have done just that.

Formulating a provision that provides Chinese courts with defined standards to follow in each of the two contexts is no easy task. The fact that U.S. courts have been unable, after nearly a century of decisions and scholarly endeavors, to develop a single test for each context and apply it consistently is persuasive proof of the difficulty.²²⁹ Therefore, the guidelines that the Author suggests for each context are merely that—a suggestion. Arguments could be made that the guidelines are not specific enough or, on the other side, are too constraining. Likewise, persuasive arguments could be made that certain factors should be included and other factors excluded. The goal is that each of the guidelines is supported by persuasive economic and legal reasons but in any case that they will spur additional thought and research into how China can develop a more comprehensive and effective veil piercing provision.

With respect to the parent-subsiary context, the veil piercing provision should include a bifurcated test.²³⁰ These two tests are: (1) the instrumentality test, and (2) the fraud test. The instrumentality test requires that the subsidiary be completely under the control and domination of the parent.²³¹ The fraud test requires that the parent's conduct in using the subsidiary be unjust, fraudulent, or wrongful toward the plaintiff.²³²

The first part of the test examines the parent corporation's relationship with the subsidiary. The mere fact that a corporation is the sole shareholder of another corporation is insufficient to permit a court to pierce the veil.²³³ In fact, many large corporations have tens or even hundreds of subsidiaries. The instrumentality test inquires whether "a [subsidiary] corporation is so organized and controlled and its affairs are so conducted as to make it a mere instrumentality or agent . . . of [the parent] corporation [such that] its separate existence as a distinct corporate entity will be ignored."²³⁴ In other words, the subsidiary has no autonomy and the parent, though in form acting through the subsidiary, "is operating the business directly for itself." In determining whether the parent and subsidiary are so closely

228. See Easterbrook & Fischel, *supra* note 8, at 110–11 (stating that courts are more willing to pierce when the shareholder is a corporation as opposed to a human). *But see* Thompson, *supra* note 2, at 1056 (stating that empirical evidence shows that courts are more willing to pierce the corporate veil when the shareholder is a human than when the shareholder is another corporation).

229. See *supra* notes 61–81 and accompanying text.

230. Meaning that both parts of the test must be satisfied before the corporate veil can be pierced.

231. PRESSER, *supra* note 3, § 1:6.

232. *Id.*

233. WORMSER, *supra* note 9, at 55–56.

234. *Id.* at 54.

connected that they are really one entity, and therefore the corporate veil of the subsidiary should be disregarded, the court should consider several questions:²³⁵

- a. Does the parent own all or most of the stock of the subsidiary?
- b. Do the parent and subsidiary corporations have common directors or officers?
- c. Does the subsidiary have grossly inadequate capital?
- d. Does the parent use the property of the subsidiary as its own?
- e. Do the directors or officers fail to act independently in the interest of the subsidiary, instead taking orders from the parent?

All of these questions need not be answered in the affirmative in order to find that the subsidiary is a mere instrumentality or agent of the parent.²³⁶ Rather, the requisite level of control can be inferred even if only a few of the criteria are met.²³⁷

The second part of the bifurcated test (the fraud test) recognizes that piercing is appropriate only if the parent uses the subsidiary in a way that harms the plaintiff creditor. In deciding whether this test is fulfilled, the court should consider the following questions:²³⁸

- a. Did the parent use the subsidiary to commit a crime or violate a statute?
- b. Did the parent strip the subsidiary of its assets, leaving no assets for the subsidiary's creditors?
- c. Did the parent use the subsidiary to engage in misrepresentation?
- d. Did the parent use the subsidiary to commit a tort?

An affirmative answer to any of these questions would be sufficient to satisfy the fraud test.

This bifurcated test—including the instrumentality and fraud tests—provides relatively clear guidelines to the courts as to what they should consider in deciding piercing cases and therefore conforms to the structure of China's judicial system. However, it also permits the courts some discretion (at the margins) in applying the doctrine. The test is rigid enough to give the courts a clear direction but flexible enough so that enterprising corporations cannot easily devise a scheme to get around it.

With respect to the human context, and similar to the parent-subsidiary context, the veil piercing provision should define the factors that a court must consider in deciding whether or not to

235. PRESSER, *supra* note 3, § 1:6.

236. *Id.*

237. *Id.*

238. *Id.*

pierce. Several factors often figure prominently in U.S. veil piercing cases: undercapitalization, fraud, commingling of assets, total domination, failure to follow corporate formalities, and diversion of funds or assets for non-corporate purposes.²³⁹ However, simply listing these factors in China's veil piercing provision will not be helpful to the courts for the reasons already discussed. For example, U.S. courts often list the failure to follow corporate formalities as a major factor in piercing decision.²⁴⁰ However, "failure to follow formalities" seems to be a general phrase which encompasses more specific actions: failure to issue stock, failure to have shareholder meetings to elect directors or prepare minutes of such meetings, and failure to approve or document transactions between the corporation and its shareholders.²⁴¹ Listing these actions simply as a "failure to follow formalities" obviates the real issue. The failure to issue stock may prejudice creditors, and if so, it is because the firm is undercapitalized.²⁴² Listing the failure to approve or document transactions between the corporation or its owner also distracts from the real issue, which is whether the shareholder is engaging in self-dealing.²⁴³ Also, the argument that the failure to hold shareholders meetings and keep minutes should lead to piercing is that if the shareholder does not respect the corporation, then the court should not either.²⁴⁴ This argument, however, "substitutes rhetoric for policy."²⁴⁵ In addition, the observance of meeting formalities would probably be immaterial to reasonable creditors.²⁴⁶ Finally, fraud is often mentioned as a reason to pierce the corporate veil.²⁴⁷ Simply saying that there was fraud, however, does little to explain the misconduct. Like failure to follow corporate formalities, it seems to be no more than a catch-all term which includes undercapitalization, self-dealing, and abusive dealings with the creditor.

The suggested guidelines for the human context, discussed below, seek to avoid general terms that actually encompass more specific conduct. They also seek to avoid the two main sources of ambiguity about veil piercing in common law jurisdictions—reasoning by pejorative and listing multiple factors without exploring the reasons why the factors contribute to a piercing decision. The provision in the Company Law should state three factors that should

239. See Mark A. Olthoff, *Beyond the Form – Should the Corporate Veil be Pierced?*, 64 UMKC L. REV. 311, 313–14 (1995) (listing factors that courts commonly rely upon when deciding whether or not to pierce the corporate veil).

240. Guvertz, *supra* note 206, at 866.

241. *Id.* at 867.

242. *Id.* at 867–68.

243. *Id.* at 868.

244. *Id.*

245. *Id.*

246. *Id.* at 869.

247. *Id.* at 871.

be considered in determining whether to pierce the corporate veil: undercapitalization, abusive dealings with the corporation's assets, and abusive dealings with the plaintiff creditor. Like the first part of the parent-subsidiary guidelines (the instrumentality test), all three factors need not be present in order to pierce. In fact, in most instances the satisfaction of only one factor should be sufficient to justify a decision to pierce.

In the United States, undercapitalization is one of the most often cited reasons for piercing the corporate veil.²⁴⁸ If the shareholders knowingly contribute too little capital to the corporation to meet the expected liabilities of the business, they are engaging in abuse of the corporate form.²⁴⁹ In addition, a corporation has a greater incentive to engage in excessively risky activities the lower the amount of its capital.²⁵⁰ Under the Company Law, a limited liability company is required to have a minimum amount of registered capital of 30,000 Yuan.²⁵¹ In addition, the amount of initial capital contributions made by all investors to a limited liability company is required to be not less than 20% of the total registered capital, and the remaining amount must be paid off within two years of the establishment of the company.²⁵² These provisions of the Company Law can provide benchmarks for whether a corporation is undercapitalized, although proof that a corporation meets these statutory minimums does not necessarily mean that the firm is not undercapitalized.²⁵³ However, the courts must be able to point to some standard to determine whether a firm is undercapitalized, and these benchmarks present clear standards. Less defined standards would risk plaguing the

248. Thompson, *supra* note 6, at 629. *But see id.* (stating that undercapitalization is not among the factors most likely to lead to piercing).

249. PRESSER, *supra* note 3, § 1:9.

250. EASTERBROOK & FISCHER, *supra* note 7, at 59.

251. The Company Law, *supra* note 5, at art. 26. RMB 30,000 Yuan is equal to about \$3700. See Exchange Rate Home Page, http://www.exchangerate.com/200plus_calculator.html (last visited Sept. 30, 2006) (calculating the conversion of Yuan to U.S. dollars). The minimum amount of registered capital of a joint stock company is RMB 5 million Yuan, equal to about \$615,000. The Company Law at art. 81; see Exchange Rate Home Page, http://www.exchangerate.com/200plus_calculator.html (last visited Sept. 30, 2006) (calculating the conversion of Yuan to U.S. dollars).

252. The Company Law, *supra* note 5, at arts. 26, 81.

253. In Germany, undercapitalization can exist in two forms: nominal or material undercapitalization. PRESSER, *supra* note 3, § 5:5. Like China (but unlike American jurisdictions), Germany has a minimum capital requirement for corporations and limited liability companies. *Id.* When the minimum capital requirement is not met, nominal undercapitalization occurs. *Id.* However, the statutory minimum "does not assure that a business will have adequate capital in order to meet its obligations." *Id.* Therefore, "material undercapitalization refers to situations in which the statutory minimum requirement is satisfied, but the owners fail to invest a sufficient amount of capital in the business." *Id.* It is still unclear, though, the extent to which German courts will pierce the corporate veil because of material undercapitalization. *Id.*

courts with the same ambiguity and inconsistency that have dominated in U.S. jurisdictions. Since the statutory minimums set a relatively low bar for capitalization, proof that a firm is not undercapitalized should not be determinative of whether the corporate veil should be pierced on its own. Further, undercapitalization should not only be measured at the beginning of the corporation's life.²⁵⁴ As Professor Thompson notes, "[u]ndercapitalization . . . is most troublesome when it reflects a unilateral change by those in control of the corporation to deprive the creditors of their reasonable expectations of repayment."²⁵⁵ Therefore, the courts should judge undercapitalization at the time the contract was executed or the tort occurred.

The second factor that courts should consider when determining whether to pierce the corporate veil to reach an individual under the Company Law is whether there have been abusive dealings with the corporation's assets. Courts often use words like "commingling" or "siphoning" to describe situations in which a shareholder is self-dealing.²⁵⁶ Self-dealing refers to a shareholder putting corporate assets to personal uses, and underlying policy supports the relevance of self-dealing as a factor in piercing decisions. In the context of contract creditors, implied (if not explicit) in any credit agreement is a promise by the corporation that the shareholders will not be free to do whatever they want with the corporate assets.²⁵⁷ If such a promise were not implied, the controlling shareholder could raid the corporation of its money and leave the creditor unpaid.²⁵⁸ Further, siphoning assets out of the corporation so that insufficient funds will be available to pay debts changes the expectations of the parties.²⁵⁹ Likewise, in the context of tort creditors, if the controlling shareholder can misappropriate corporate assets to personal uses before tort victims can get or enforce a judgment. This leaves the corporation with less incentive to insure, and the goal of internalizing the costs of accidents is not met.²⁶⁰ Therefore, courts should pierce the corporate veil when shareholders have been self-dealing.

Finally, courts should ask whether there have been abusive dealings with a plaintiff creditor. Sometimes referred to as fraud, this factor includes: false representations made by the shareholder to the

254. Thompson, *supra* note 6, at 630.

255. *Id.*

256. Gevurtz, *supra* note 206, at 875.

257. *Id.* at 875. This promise does not apply, of course, if the creditor, aware of conduct that might constitute self-dealing, nevertheless chooses to do business with the corporation. *Id.* at 876.

258. *Id.* at 875.

259. Thompson, *supra* note 6, at 628.

260. Gevurtz, *supra* note 206, at 876. Further, there is less incentive to make sure the costs of the corporation's goods or services fully reflect the likely costs of accidents. *Id.*

creditor about the corporation's financial status, the shareholder's promises relating to corporate performance, and representations by the shareholder that lead the creditor to believe that someone other than the corporation stands behind the debt.²⁶¹ Deliberate deception by a shareholder about the financial health of the corporation is clear grounds for shareholder liability.²⁶² Likewise, it is fraud for a controlling shareholder to promise certain corporate performance when, "at the time of the promise, the . . . shareholder intended to have the [corporation] default."²⁶³ The final situation in which fraud typically arises is when a shareholder casts oral assurances as a personal guarantee that the debt will be paid.²⁶⁴ Often such comments are too vague or ambiguous to establish a contract,²⁶⁵ but if the creditor acted on such assurances, then there is a strong argument that the creditor was defrauded. These three examples represent instances in which wrongful conduct by the shareholder changes the bargain made by the parties, therefore justifying piercing the corporate veil.²⁶⁶

B. *Distinguishing Between Tort and Contract Creditors*

U.S. "courts are more willing to disregard the corporate veil in tort than in contract cases."²⁶⁷ The distinction between tort (involuntary) and contract (voluntary) creditors follows from a moral hazard problem: "insiders in a . . . corporation can transfer costs of accidents to those who deal with the corporation."²⁶⁸ Further, "contract creditors have the opportunity to investigate their corporate debtors, and thus they can take account of the risk posed by limited liability, and adjust their interest rates accordingly."²⁶⁹ Tort creditors, on the other hand, do not have the opportunity to investigate the tortfeasor before the tort is committed. Therefore, the

261. *Id.* at 871-73. See also Easterbrook & Fischel, *supra* note 8, at 112 ("In all these situations, creditors are unable to assess the risk of default accurately and thus the probability that the firm will engage in excessively risky activities is increased.")

262. Gevurtz, *supra* note 206, at 871. It should also be noted that few courts, if any, will be willing to pierce based on inadequate capitalization when the creditor was fully informed of the corporation's weak financial health and yet still chose to do business with the corporation. *Id.* at 872.

263. *Id.* However, the mere fact that a corporation does not perform does not turn the promise into fraud. Fraud requires that the speaker have never intended to perform. *Id.*

264. *Id.* at 873.

265. *Id.* at 874.

266. *Id.* at 871-73; Thompson, *supra* note 6, at 629.

267. Easterbrook & Fischel, *supra* note 8, at 112; but see Thompson, *supra* note 2, at 1068-69 (stating that his empirical study found a smaller percentage of tort cases than contract cases in which the court pierced the veil).

268. Easterbrook & Fischel, *supra* note 8, at 112; Thompson, *supra* note 2, at 1068.

269. PRESSER, *supra* note 3, § 1:10.

veil piercing provision should provide that the guidelines should be applied more often to tort creditors than to contract creditors. Said differently, it should be easier for a tort creditor to reach the assets of a shareholder than for a contract creditor.

V. CONCLUSION

Veil piercing is an important doctrine in corporate law because it deters abuse of the corporate form. It also decreases the incentive created by limited liability to engage in overly risky activities. While China has taken an important step in its corporate law by codifying the doctrine in the Company Law, it has not gone far enough in defining the standards that courts should use when determining whether to pierce the corporate veil. The Company Law should distinguish between situations where piercing would reach another corporation and where piercing would reach an individual. Further, the Law must give the courts guidelines to follow each situation. This Note outlined guidelines that may be used. Finally, the Company Law should distinguish between tort and contract creditors.

China's legal system presents unique problems not found in the common law system in the United States. Chinese law only allows courts to interpret legislative mandates, thus the doctrine cannot be amended through common law changes. China will have to continue to amend the Company Law, and the veil piercing provision in particular, to keep up with new situations.

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