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Dispute Resolution

Statutory Circumstances for Shareholders to Undertake Liability for Company Debts and Related Judicial Practices

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The independence of the corporate form and the limited liability of shareholders are two fundamental principles stipulated in the PRC Company Law (hereinafter referred to as "**Company Law**"). Article 3 of the Company Law reflects such principles by stating that a company shall be an enterprise legal person who possesses independent legal person property and enjoys legal person property rights, a company shall be liable for its debts to the extent of all of its assets, the shareholders of a limited liability company are liable to the company to the extent of its respective subscribed capital contribution, and the shareholders of a company limited by shares bear the liabilities of the company to the extent of their respective subscribed shares. Given this, the general understanding is that a company is liable for its debts only to the extent of its own assets, and the shareholders shall not be liable for the company's debts.

However, in practice some shareholders or de facto controllers of certain companies deliberately co-mingle company assets with their own or that of their associated companies, through a number of methods, such as related party transactions, creating false debts, transferring of company assets, concealing company assets, etc., thus maliciously infringing upon the rights and interests of the company and eventually leading to the company's insolvency, making any favorable judgment essentially unenforceable. In other words, creditors who win in such judicial proceedings are not able to recover due to the debtor's insufficient corporate assets. In practice, such behaviors have become increasingly common and many debtors are using these tactics to circumvent their financial obligations owed to creditors, thereby not only seriously infringing upon the interests of creditors, but also ruining the social credit and the business environment as a whole.

The Company Law and several related judicial interpretations provide a variety of legal remedies for creditors with respect to shareholders or de facto controllers that seek to evade the debts of

their debtor companies. By looking at the relevant laws and regulations, researching the underlying legislative background and legal theory, and by citing recent court decisions, this article summarizes particular circumstances where creditors have been able to directly claim against the shareholders or de facto controllers for the debts owed by the debtor companies.

I. Piercing the Corporate Veil

According to Article 20 of the Company Law, the shareholders of a company shall abide by laws, administrative regulations and articles of association and exercise shareholders' rights in accordance with the law, and shall neither damage the interests of the company or other shareholders by abusing shareholders' rights nor damage the interests of any creditor of the company by abusing the company's independent status as a legal person or the limited liability of shareholders. The same Article also stipulates that shareholders who evade the payment of debts by abusing a company's independent legal person status or the limited liability of shareholders shall be held jointly and severally liable for the debts of the company.

The aforesaid provisions not only prevent the shareholder from abusing the independence of the company's legal status and the limited liability of shareholders, but also describes the legal liability for those who have breached obligations, also known as the theory of "Disregarding the Corporate Entity" or "Piercing the Corporate Veil" under the Company Law. However, no clear judicial interpretations have been established to clarify what kind of conduct constitutes an abuse of the independent legal status and the limited liability of shareholders as the basis for applying this provision, and this has created fierce controversy in scholarly circles and judicial practice.

In 2009, the Shanghai High People's Court promulgated Guidelines of Civil Adjudication Tribunal No. 2 of Shanghai Higher People's Court on Several Issues of the Trial of cases concerning Disregarding the Company Personality (hereinafter referred to as the "**High Court Guidelines**") aiming to provide detailed guidance on the issue. According to the High Court Guidelines, when a company is significantly lacking company capital, or is difficult to distinguish from its shareholders, or a shareholder improperly dominates or controls the company, it is possible for the court to determine these situations to be forms of abuse of the independent legal status of a company and the limited liability of shareholders. The High Court Guidelines further stipulate standards for the determination of these three circumstances. Where any shareholder fails to fulfill or fully fulfill its capital contribution obligations, or withdraws subscribed capital after the establishment of the company, the company capital shall be deemed to be insufficient. Where continuous and widespread commingling of property, businesses, personnel and premises between shareholders and the company is found, it can be concluded as a serious mixing of personal and company identity. Where any shareholder illegally conceals or transfers

company property through related-party transactions, it may be concluded that the shareholder illegally dominates or controls the company.

The Supreme People's Court holds a similar opinion in judicial practice. In the case regarding a loan agreement dispute between Hebei Jixing Freeway Co., Ltd. ("**Jixing Company**") and Jingyu Freeway Co., Ltd. ("**Jingyu Company**") ([2011] Min Shen Zi No. 289), the retrial applicant, Jixing Company, claimed that He Yuhua had abused his shareholder rights as the de facto controller of Jingyu Company, Kangyong Company and eight other companies. In fact, Jingyu Company directly exercised the shareholder rights of Kangyong Company and the eight other companies, causing a severe mixing of the establishment, capital contribution, registered address, finance and personnel between Jingyu Company, Kangyong Company and the eight other companies, thus gravely infringing upon the interests of creditors. Therefore, Jixing Company contended, Kangyong Company and the eight other companies should bear joint and several liability for the debts of Jingyu Company. The Supreme People's Court found that, according to Article 3 of the Company Law, the independence of property is foundational to the independence of corporate entity status. Therefore, in order to successfully prove a mixing of identity has occurred between a shareholder and a company, the first step is to determine the independent status of the company property, namely whether the company property has been comingled with its shareholders. Additionally, the registered address, organization of personnel, and the distribution of company profits shall also be taken into consideration. Although the Supreme People's Court rejected the claim of the retrial applicant on the grounds of insufficient evidence, its analysis clearly set out the criteria for determining the mixing of corporate identity between a shareholder and a company.

It is worth noting that the theory of "Disregarding the Corporate Entity" is generally believed to be confined to Vertical Disregard (i.e., only applicable to shareholders of the company) but excludes Horizontal Disregard (i.e., cannot be applied to the company or the affiliated companies de facto controlled by shareholders). Nonetheless, in the aforementioned case ([2011] Min Shen Zi No. 289), the Supreme People's Court appears to have tacitly approved the Horizontal Disregard of Personality, because the court only rejected the retrial applicant's claim on the grounds of insufficient evidence rather than from the aspect of application of law. Besides this, it seems that the Supreme People's Court clearly stands for the Horizontal Disregard of Corporate Entity in its later judicial practice. In the 15th Guiding Case, Xugong Group Engineering Machinery Co., Ltd V. Chengdu Chuanjiao Industry and Trade Co., Ltd and Other Respondents on Dispute over Purchase and Sales Contracts, the court confirmed the mixing of corporate identity between the debtor and two affiliated companies. The two affiliated companies were found to be subject to joint and several liability for the repayment of the debts to the creditor under the provisions under Article 20 of the Company Law.

Another crucial procedural issue that needs to be mentioned is whether a creditor must first have a disputed debt judicially confirmed and fail to resolve the debt before invoking Article 20 paragraph 3 of the Company Law in order to initiate a lawsuit on the theory of piercing the corporate veil. In other words, is the creditor entitled to directly file a lawsuit against the debtor company and its shareholders claiming repayment of debt? No clear provision regarding this question has been found in relevant statutes. Analyzing from a legal principle perspective, the basis for a lawsuit based on piercing the corporate veil is the joint tortious act by the debtor company and its shareholders. The losses suffered by creditor are due to the debtor company's inability to repay the debt, and are thus triable in the lawsuit as a factual issue. As a result, it is not inappropriate for a creditor to sue a debtor company and its shareholder jointly in a single lawsuit. The High Court Guidelines shares the same opinion toward this matter. Article 3 paragraph 3 of the High Court Guidelines stipulates "When the debt between a company and its creditor, either arising from contract or tort liability, has not been confirmed by effective judicial documents, and the company creditor has filed a piercing corporate veil suit claiming liability of a company shareholder, the court shall explain to the creditor, and join the company in the lawsuit as a co-defendant upon application of the creditor." Article 4 also provides that "when the company creditor has filed lawsuit based on contract or tort liability against the company and subsequently claims for joint and several liability of the company shareholders for their abuse of independent corporate entity status or limited liability of shareholders, the court may grant the creditor, prior to the deadline of adducing evidence, the right to add new claims or new defendants to the lawsuit."

II. Shareholders Fail to Fulfill Capital Contribution Obligations

Article 13 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (III) (hereinafter referred to as "**Company Law Judicial Interpretation (III)**") provides that the People's Courts shall uphold supplemental compensatory liability claims of any company creditor against a shareholder who has not fulfilled or fully fulfilled its capital contribution obligations to the extent of the capital not so contributed and interest for the part of any company debts that the company is unable to repay. Such claims shall not be upheld in the event that the shareholder has already borne this liability.

According to the abovementioned provision, the controversial issue in judicial practice is whether creditors have the right to claim against shareholders to bear supplemental compensatory liability before the maturity of their capital contribution obligations. In 2015, Civil Adjudication Tribunal No. 2 of the Supreme People's Court expressed its view of this issue through Provisions on Several Issues Concerning the Current Trials of Commercial Cases. The court held that a shareholder would not be forced to perform its capital contribution obligation prior to maturity because the company's inability to repay a single creditor's debts

must necessarily mean that the company is unable to pay off its debts as they come due, its assets are not sufficient to pay off all its debts, or that the company is insolvent. Therefore, the court reasoned, the company met the conditions for bankruptcy as stipulated in Article 2 of the Enterprise Bankruptcy Law of the People's Republic of China (hereinafter referred to as the "**Bankruptcy Law**"). In such case, the court reasoned, the interests of all the creditors shall prevail, and to allow for a single lawsuit filed by one creditor is not in conformity with the legislative spirit of Articles 31 and 32 of the Bankruptcy Law. Under such circumstances, creditors shall submit a bankruptcy application and request the shareholders to perform their capital contribution obligations in advance in accordance with Article 35 of the Bankruptcy Law, so as to protect the interests of all the creditors. The above opinion of the Civil Adjudication Tribunal No. 2 of the Supreme People's Court has legal basis and represents the dominant view in judicial practice.

No. 1 Intermediate People's Court of Shanghai held the same opinion in a case concerning a loan agreement dispute between Shanghai Jinlang Spray Technology Co., Ltd. ("**Jinlang Company**") and Honghuo (Shanghai) International Trade Co., Ltd. ("**Honghuo Company**") ([2016] Hu Yi Min Zhong Zi No. 2471). According to Article 35 of the Bankruptcy Law, the advance performance of the capital contribution obligations is premised upon the acceptance of a bankruptcy application by the People's Court, and Article 22 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (II) (hereinafter referred to as "**Company Law Judicial Interpretation (II)**") stipulates that capital contributions not paid by any shareholder of the company shall be treated as liquidation property only in the process of dissolution of the company. Based on the above regulations, if any creditor plans to urge a shareholder that is not fully paid-in to perform its capital contribution obligations in advance, there should be a statutory requirement or mutual agreement. In this case, the appellant had not reached an agreement with any shareholder of Honghuo Company, and Honghuo Company had not entered into a bankruptcy or dissolution procedure. Therefore, the creditors had neither legal merit nor factual basis to require the shareholders to perform their capital contribution obligations prior to the maturity. Meanwhile, this court deemed that it contradicts the independence of the corporate entity and the limited liability of shareholders to request the shareholders to perform their capital contribution obligations in advance once the company has failed to repay its debts.

However, some courts have held the opposite point of view. In the case Hangzhou Dingzheng Packaging Material Co., Ltd. V. Tang Huaizhong Company on Dispute over the Responsibility for the Damages of the Creditors ([2016] Zhe 0111 Min Chu No. 1150), Hangzhou Fuyang District People's Court ruled that the debtor company was unable to repay its debts and thus the shareholder had lost its privilege to withhold capital contributions until the contribution term date stipulated in the company's articles of association, and that the shareholder must therefore make advance capital contributions to the company. In other words, the shareholder is granted

the privilege to time the making of its capital contributions, but that privilege cannot be used to endanger the legitimate rights and interests of creditors by taking advantage of the company's independent legal status to shift business risk. In the event that the capital contribution obligation has not reached maturity but the debtor company is already unable to repay its debts, the creditor the shall have the right to claim against the shareholders to bear supplemental compensatory liability to the extent of the non-contributed capital for the portion of the debt that the company was unable to pay off.

Moreover, it is worth noting that, according to Article 18 of the Company Law Judicial Interpretation (III), Where any shareholder of a limited liability company transfers its equity without fulfilling its capital contribution obligations and the transferee is aware of or should have been aware of such fact, creditors of the company may sue the shareholder in accordance with Article 13 of the Company Law Judicial Interpretation (III) and request the transferee to bear joint and several liability for the company's debts. This provision could further prevent shareholders who have not fully fulfilled their capital contribution obligations from effectively escaping the debts of the company by transferring equity ownership.

III. Shareholders Withdraw Contributed Capital

Article 14 of the Company Law Judicial Interpretation (III) states that "where any creditor of the company claims against the shareholder who withdraws contributed capital to bear supplemental compensatory liability to the extent of capital withdrawn and the interest thereon for the part of the company's debts that the company is unable to repay, and against other shareholders, directors, senior managers or de facto controllers who assist said shareholder to withdraw capital to bear joint and several liability therefor, the People's Court shall sustain; in the event that the shareholder who withdraws capital has borne foregoing liability, and other creditors file same claims, the People's Court shall not sustain."

There is no explicit or clear provision in relation to the definition and specific form of what conduct constitutes withdrawal of a company's registered capital. According to Article 12 of the Company Law Judicial Interpretation (III), the following actions of shareholders or de facto controllers may be considered as withdrawals of company capital: (i) preparation of false financial statements to increase non-existent profits and distribute the same; (ii) payments of contributed capital by fabricating credit-debt relationships; (iii) payments of contributed capital through related-party transactions; and (iv) any other acts of withdrawing capital without legal procedures.

Based on the aforesaid provisions, if any creditor can prove that any shareholder or de facto controller has committed the behavior of withdrawing capital from the company, the creditor may bring a lawsuit against the shareholder or de facto controller to claim for supplemental compensatory liability for the debts that the company is unable to repay.

IV. Shareholders Violate Their Statutory Obligations during the Liquidation Process

Article 183 of the Company Law stipulates that the liquidation group of a limited liability company shall be comprised of its shareholders, while a joint stock limited company shall be comprised of its directors or any other individuals appointed by the general meeting. Article 189 of the same law stipulates that the members of a liquidation group shall, during the course of liquidation, carry out their duties and perform their obligations in accordance with the law. Any member of a liquidation group who causes any loss to the company or to any of its creditors either intentionally or due to his gross negligence shall be liable to compensate the affected party.

In light of the above regulations, where any shareholder acts as a member of the liquidation group but fails to perform its obligations in accordance with the laws and regulations and causes losses to any creditors of the company, that shareholder shall bear tort liability for the losses. Company Law Judicial Interpretation (II) provides detailed explanations of and rules for this issue as follows:

Provisions of Law	Illegal Act	Accountable Party	Liability
Article 11 paragraph 2 of the Company Law Judicial Interpretation (II)	Failure to perform notification and public announcement obligations by a liquidation group for a company will prevent creditors from promptly declaring and resolving their interests	**Members of the liquidation group**	Bear liability for any creditor losses arising therefrom
Article 15 paragraph 2 of the Company Law Judicial Interpretation (II)	The implementation of an unconfirmed liquidation proposal	Members of the liquidation group	Bear liability for any creditor losses arising therefrom
Article 18 paragraph 1 of the Company Law Judicial Interpretation (II)	Failure to establish a liquidation group within the statutory time limit and to commence the relevant liquidation work by shareholders of a limited liability company or directors or the controlling shareholder of a company limited by shares results in any impairment, drain, or the destruction or loss of company property.	The shareholders, directors or the controlling shareholder of the limited liability company	Bear liability for any loss of the creditors arising therefrom
Article 18 paragraph 2 of the Company Law Judicial Interpretation (II)	Delay in the performance of obligations by shareholders of a limited liability company or directors or the controlling shareholder of a joint stock limited company results in the loss of the main assets, account books, material documents or other items of the company which cause the liquidation of the company to become impossible.	The shareholders, directors or the controlling shareholder of the company	Bear joint and several liability for the debts of the company
Article 18 paragraph 2 of the Company Law Judicial Interpretation (II)	The circumstances described above in Art. 18, paras.1 and 2 are caused by the *de facto* controller of the company	*De facto* controller of the company	Bear corresponding civil liability for the debts of the company
Article 19 of the Company Law Judicial Interpretation (II)	Where shareholders of a limited liability company, directors or the controlling shareholder of a joint stock limited company,	The shareholders, directors, controlling	Bear corresponding liability for the debts of

	or the *de facto* controller of the company cause any loss to the creditors of the company as a result of any malicious disposals of company property upon the dissolution of the company or instead of carrying out the relevant liquidation work in accordance with the law, the company goes through the registration formalities for legal person cancellation by deceiving a company registration authority with a false liquidation report.	shareholder or *de facto* controller of the company	the company
Article 20 paragraph 2 of the Company Law Judicial Interpretation (II)	Where shareholders of a limited liability company, directors or the controlling shareholder of a joint stock limited company, or the *de facto* controller of the company make a cancellation registration for the company without going through the relevant liquidation procedures, making it impossible to commence the liquidation process.	shareholders, directors, controlling shareholder, or *de facto* controller of the company	Bear liability for repaying the debts of the company
Article 23 paragraph 2 of the Company Law Judicial Interpretation (II)	Where a violation of laws, administrative regulations or the articles of association committed by any member of a liquidation group of a company in carrying out the relevant liquidation work causes any loss to the company or any creditor of the company	Members of the liquidation group	Bear liability for compensation

Civil liability as described under the foregoing regulations can be seen as taking two forms. One form is liability for damages, namely to compensate for the loss caused by the illegal conduct or to repay the debts of the company. Theoretically, the scope of the liability is determined after the liquidation of the company is finalized. While in judicial practice, the People's Courts tend to direct shareholders to assume the liability for the debts which the company is unable to repay without considering the causation between the illegal conduct of shareholders and the resulting injury to the creditors. The second form is joint and several liability for the debts of the company, which usually applies to situations where any responsible person commits illegal conduct and which results in the liquidation of the company becoming impossible. In addition, no matter what kind of liability shareholders bear, all relevant shareholders shall bear joint and several liability for the external debts of the company. In terms of shareholder liability internally, the shareholders may be held liable to the extent of their respective faults in accordance with Article 21 of the Company Law Judicial Interpretation (II).

V. Shareholder Promises to Assume Company Debt

Article 20 of the Company Law Judicial Interpretation (II) provides that where any shareholder of a company or any third party promises to assume debts of the company when the company makes a cancellation registration with a company registration authority without going through the liquidation procedures, the People's Courts shall support the claims of any creditor of the company for civil liability against the shareholder or third party in accordance with the law.

In accordance with the aforesaid regulation, parties liable for the liquidation shall resolve debts of the company in accordance with laws during the liquidation proceeding. Creditors are entitled to request shareholders to undertake liability for debts of the company in the event of an unlawful liquidation and the shareholders had made a commitment to be liable for debts of the company when carrying out deregistration formalities. The issue is what kind of shareholder commitments constitute promises to assume the debts of the company under this regulation. Below are some cases that provide guidance in this regard.

In the dispute on compensation for property damage between Dandong Hongyun Estate Management Limited Company ("**Hongyun Company**") and Guan Shuping [(2015) Dan Shen Min Zai Zi No. 00022], since Hongyun Company failed to perform routine public utility maintenance responsibilities, a water pipe eventually burst and resulted in property damage to Guan Shuping and others. Hongyun Company was found to be liable for those damages. During the retrial procedure in Dandong Intermediate People's Court, Hongyun Company completed liquidation and deregistration formalities. However, the court finally ruled that the shareholders Qu Shouming and Li Li, as successors of the rights and obligations of Hongyun Company, should undertake liability to compensate Guan Shuping since Qu Shouming and Li Li had committed in the liquidation plan that "should there be any other matters not mentioned herein, all shareholders should undertake responsibility."

In the dispute on liquidation liability between Guangdong Energy Engineering Bureau of China Energy Engineering Group ("Energy China GEEB") and Shantou Jian'an (Group) Company [(2015) Zhu Fa Min Er Zhong Zi No.356], the court found that Energy China GEEB made no public announcements and did not notify its creditors as required by law during the liquidation procedure of its subsidiary Zhuhai Company. However, as Energy China GEEB had made a commitment in the liquidation plan that if related debts need to be repaid in the future, the investor will continue to undertake the repayment obligations. The court found this commitment to be legally binding, and thus Energy China GEEB bore liability in accordance with the judgment of the court.

VI. Conclusion

All of the above circumstances discussed in this article are special provisions set forth in the Company Law to protect creditors of companies, and which act to provide creditors with powerful legal tools. When dealing with debt disputes, creditors may find themselves overwhelmed by debtors' attempts to evade repayment if they only seek remedies under the Contract Law and focus on the assets and solvency of the debtors alone. Certain provisions in the Company Law grant creditors not only the legal right to claim against shareholders and de facto controllers but also provide actionable guidance on how to file a direct lawsuit against the responsible shareholders, affiliates or de facto controllers as parties in civil proceedings and to take relevant property or evidence preservation action, thereby providing creditors with better and broader solutions for handling debt disputes.

Important Announcement

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