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RESPONSIBILITY OF PARENT COMPANIES FOR THE DEBTS OF THEIR SUBSIDIARIES AS A RESULT OF PIERCING THE CORPORATE VEIL

Entrepreneurship means an independent, proactive, comprehensive for-profit activity undertaken at one's own risk. Commercial risk implies possible negative material consequences of entrepreneurial activity that may arise in the course of running a business, other than those resulting from the entrepreneur's faults. Therefore, one of the attributes of entrepreneurial activity is its risky nature which means that an entrepreneur, in pursue of profit, is likely to incur loss if he fails to correctly assess relevant risks.

Hence, in order to reduce risks, parent companies create subsidiaries with limited proprietary responsibility. Thus, the parent company grows more sustainable through sharing its risks with its subsidiaries and branches [1].

The issue of bringing a parent company to responsibility for the debts of its subsidiary has been in the focus of recent discussions. To put it more precisely, experts insist on the need to increase legal responsibility of a parent company for the activities of its subsidiaries.

It is widely known that a subsidiary company is a separate legal entity. However, its separate status is rather questionable. This is because activities of any legal entity — whether a subsidiary, a joint stock company with an enormously complicated shareholding structure, or a limited liability company — depend, to an extent, on the decisions of its shareholders and founders.

Legal status of subsidiary company has often been a point of discussion in legal literature. The problem here lies in the fact that Ukrainian law-makers failed to define a subsidiary company, but used this term in some general or specific laws and secondary legislation [2, p. 225].

Thus, according to the Law of Ukraine "On Banks and Banking Activity" No. 2121-III of 7 December 2000, a subsidiary company is a legal entity controlled by another legal entity (parent company). On the other hand, the

State Classification 002:2004 *Classification of business entities* referring to Articles 63, 126 of the Economic Code of Ukraine, defines a subsidiary as a company whose sole founder is another company (where one company is controlled by another) [3].

Moreover, it is interesting that the Civil Code of Ukraine offers no explanation of what a subsidiary company is. At the same time, according to Article 63, paragraph 8 of the *Economic Code of Ukraine Types and forms of business entities*, where one company is controlled by another, as provided for by Article 126 of this Code, such company shall be deemed subsidiary. Article 126 of the Economic Code of Ukraine defines the status of associated companies and holding companies. It says that associated companies (business associations) are groups of business entities with the status of legal entity that are interdependent in terms of economic and organizational relations as a result of contributions in the authorized capital and/or participation in the management. Control over a company, for the purposes of deciding whether it can be qualified as subsidiary, may be simple or decisive. There is simple control in terms of relations between associated companies if one of the companies can veto the decisions of the other (dependent) company that are supposed to be passed under the law and/or statutory documents of such company by the qualified majority of votes. Decisive control in respect of associated companies exists if control and subordination relations are established between them as a result of the parent company being the majority shareholder in the authorized capital and/or having the majority of votes in the general meetings or other managing bodies of another (subsidiary) company, particularly, if such parent company holds a controlling stake in the subsidiary company. State registers may contain information about simple or decisive control over the controlled (subsidiary) company. This information may also be published according to the law. Therefore, shareholding and/or participation in the company management are the key category that defines the term "subsidiary company" used in the Economic Code of Ukraine. Hence, according to Article 63, paragraph 8, and Article 126 of the Economic Code of Ukraine, a subsidiary company may have more than one founder. Moreover, pooling of capital or participation in the management are typical for a company as a business entity, including for a single founder company.

Some authors, based on the results of comparative analysis of laws of various jurisdictions, have come to the conclusion that a subsidiary company is a legal entity whose management and activities are controlled by another legal entity (parent company) as a result of the latter's holding the majority of votes in the subsidiary company or under the relevant subordination agreement between the parent and subsidiary companies [4, p. 7].

The need of defining the legal status of a subsidiary company has been a frequently raised issue. So a subsidiary company should be deemed a company created as a business entity whose corporate rights are owned by another legal entity, on which basis the latter influences the management (or manages) such subsidiary company. A subsidiary company is not responsible for the debts of the parent company. In case the latter goes bankrupt, the equity rights of the parent company will be exercised on a competitive basis, and proceeds of sale thereof will be used to satisfy the claims of the parent company's creditors. This enables survival of the subsidiary company in any case, even if such subsidiary is a unitary company that has only one founder and is not the owner of its property [5, p. 6].

It should be clarified here that a parent and subsidiary companies form a business group that equals to a "holding" in the American law, and a "concern" in the European countries.

The following are classic forms of responsibility of a parent company for the debts of its subsidiary company: 1) joint responsibility of a parent company under agreements signed with the subsidiary company; 2) subsidiary responsibility of a parent company for the debts of the subsidiary company if the latter is insolvent; 3) responsibility of a parent company to the shareholders of its subsidiary company for the loss incurred by the latter through the fault of the parent company [6, p. 468].

When analysing legal relations between parent and subsidiary companies, it is arguable that they possess different property, regardless of the rights on which basis such property was transferred to the subsidiary company – be it the right of ownership or full economic control (which is a widespread practice today). Therefore, the rule of several proprietary responsibility of the parent company must apply, and the subsidiary company should not be brought to responsibility for the debts of its parent company. This idea makes it difficult to identify the share of a subsidiary company as the latter's relations with the parent company are so close that in case of winding up of the parent company its subsidiary may no longer exist [5, p. 5].

However, the actual dependence of a subsidiary company from the parent company has repeatedly brought the question of practicality of the introduction of joint responsibility of a parent and subsidiary companies under agreements entered into by the latter with the purpose to follow the binding instructions of the parent company, as well as subsidiary responsibility of a parent company for the debts of its subsidiary in case of bankruptcy of the latter through the fault of the parent company [4].

Foreign law, including the case law, knows two main concepts of bringing a parent company to responsibility where such company has an influence over

the activities of the legal entities it controls: – one is typical for the common law and suggests that abuse of rights is an important factor in bringing the dominating member of the group to responsibility; – another is typical for the continental law and allows brining a parent company to responsibility provided a cause-and-effect relationship was proven between actions of the parent company and loss incurred by the subsidiary company [7].

Piercing/lifting the corporate veil (hereinafter "PCV"), a well-known doctrine in the foreign case law, is in the core of those two concepts. This doctrine suggests that responsibility of a legal entity, in exceptional cases, may be imposed on its founders (shareholders) or persons that control it and whose actions have caused adverse effects for the legal entity. In this context, the corporate veil, in its widest sense, is a tool that separates the assets of a legal entity from the assets of its founders (shareholders) or controlling persons. In the context of the issues discussed here, the PCV doctrine is widely used in bringing a parent company to responsibility to creditors of the subsidiary company in case the latter is insolvent. It should be added that foreign legal experts quite often apply other doctrines that regulate the institute of responsibility of controlling companies to the controlled companies. But all of them, in fact, only supplement and clarify the piercing the corporate veil doctrine. Alter ego, instrumentality and agency concepts are most widely-used in this series [8], but there are more of them.

The case law on the matter discussed here is based on the case Japan Petroleum CO. (Nigeria) LTD. vs Asland Oil [9], where the parent company was brought to responsibility for the debts of its subsidiary as the latter had been proven to be the de facto agent of its parent company.

At the same time, if we analyse similar cases, the court decisions in terms of a possibility of bringing a parent company to responsibility for the debts of its subsidiary were less certain. This is because the courts treated a subsidiary company as a mere instrumentality, or alter ego of the parent company [10], others referred to agency relations between two corporations [11], while in most cases, the process of bringing a parent company to responsibility for the debts of its subsidiary was subject to the piercing the corporate veil doctrine.

The case Pauley Petroleum, Inc. vs Continental Oil Co [12] is particularly interesting in this context. The court came to the conclusion that a subsidiary company should be treated as a separate entity only when this is reasonable for the purposes of preventing fraud or unfair treatment on the part of the parent company.

Based on the analysis of the legislation and case law, many authors expressed their vision of the nature, grounds and procedure of bringing a parent company to responsibility under agreements with its subsidiary entered

into by the latter pursuant to the binding instructions of the parent company: 1) this is extra-contractual responsibility (not arising out of the agreement entered into by the parent company and controlled company); 2) it is the creditor of the subsidiary that has the claim right, not the company itself; 3) the joint responsibility principle authorizes the creditor to claim the outstanding obligations from either the parent or subsidiary company at its own discretion partially or in full; 4) where such cases are brought, the parent and subsidiary companies are both engaged as co-respondents according to the procedure prescribed by the procedural law; 5) subsidiary relations must be proven in court proceedings [13].

Subsidiary relations deserve special attention in this respect, as identifying grounds to be taken account of by the court to solve a case may, in fact, turn out to be a rather baffling task. Subsidiary relations are deemed obvious if the parent company owns 100% of the authorized capital of the subsidiary company, or if the parent company directly or indirectly owns or co-owns a share that represents the equivalent of at least 50% of the authorized capital or votes of the subsidiary company, or has a decisive influence on the management or activities of the subsidiary company under a relevant agreement or otherwise.

In view of the aforesaid, it is necessary to consider whether a parent company may issue instructions for its subsidiary. The situation described here pretty often causes abuse of various kinds on the part of a parent company because in most cases, direct or indirect instructions influence further activities of the controlled company. This, in its turn, may cause adverse effects not only for the subsidiary, but also for the whole business group. The aforementioned shows a certain interrelation between the existing control and the possibility for a parent company to issue instructions for its subsidiary. It causes substantiation of interests to an extent, when activities of a subsidiary company depend directly on the interests of the parent company.

On the other hand, according to the law of Germany, the right of a parent company to issue instruction for its subsidiary does not necessarily imply actual control over the subsidiary [14].

According to the Law of Ukraine “On Joint Stock Companies” No. 514-VI of 17.09.2008, control as decisive influence or a possibility of decisive influence on business activities of a business operator is conducted, in particular, through the right of ownership or use of all their assets or a significant portion thereof, the right of decisive influence on their composition, voting results, and passing of decisions by the business operator’s management bodies, as well as transactions that allow identifying the conditions of business activity,

giving binding instructions or perform the function of the business operator's management body.

Therefore, the fact that a parent company holds control over its subsidiary may be proven by tests that constitute grounds for applying the doctrine of piercing the corporate veil:

1) the parent and subsidiary companies have the same directors; 2) the parent and subsidiary companies share the office premises; 3) the parent company finances the subsidiary company; 4) the subsidiary company carries out no activities other than those related to the parent company; 5) the parent company wound up the subsidiary company; 6) the parent company pays salary to the employees of the subsidiary company and covers its costs; 7) members of the management and control bodies of the parent and subsidiary companies are mostly the same persons; 8) shareholders and managers of the parent and subsidiary companies have family or other interpersonal relations between them; 9) shared actual staff, decision-making centre and document archive; 10) performance of the functions of supreme management by persons whose education, profession and position in another company de facto disqualify them as performers of such functions; 11) making unfavourable deals and other agreements on a regular basis, where such deals and agreements offer no economic profit and are unjustified for the controlled company; 12) the parent and subsidiary companies have the same legal representatives and advisors, including general contact persons and postal addresses; 13) the parent company uses the property of the subsidiary company as its own property; 14) the subsidiary company follows basic corporate formalities, such as keeping separate books and records and holding of the general meetings of shareholders and directors [15].

The category of control is considered to be crucial in terms of responsibility of a parent company for the actions of its subsidiaries to third parties.

At the same time, K. A. Aristova insists that the model of brining a parent company to responsibility for the debts of its subsidiary required proving of three facts by the claimant [16, p. 118]: 1) a subsidiary company is only instrumentality of the parent corporation in case the latter holds excessive control; 2) the parent corporation exercises such control with the view to commit fraud or other illegal actions; 3) the claimant incurred inequitable loss as a result of the parent corporations' actions [17].

At the same time, in Switzerland, for example, the criteria of control and domination of a parent company over the subsidiary company, as well as grounds for applying the doctrine of piercing the corporate veil are the following: the capital of the subsidiary company is used for the purposes of achieving objectives and tasks other than those it was creation for, and

for the purposes of activities other than those it plans; same administration, management and property [18, p. 96].

In view of the aforesaid, it is reasonable to consider a parent and subsidiary companies as one organizational unit, since a subsidiary company will always depend on the instruction of the parent company, i.e. to the benefit of the latter. Hence, there is always some form of control of a parent company over subsidiary.

Moreover, we are convinced that in order to lift the corporate veil, it is necessary, in addition to all the aforesaid, examine the cause-and-effect relationships between the actions of a parent company in respect of the subsidiary company and the loss incurred by the latter. However, it might be difficult to prove this fact in practice.

Summarizing the point of brining a parent company to responsibility for the debts of its subsidiary through applying the doctrine of piercing the corporate veil, it should be mentioned that back in 1931, Frederick J. Powell published the work based on the results of his fundamental study named *Parent and Subsidiary Corporations* [19], in which the author explained in detail and reasoned the practicality of applying certain criteria for piercing the corporate veil. The rules set out by the scientist are now known as Powell's three-factor test and widely used in foreign case law as grounds for applying the PCV doctrine.

Generally speaking, the study of grounds for bringing a parent company to responsibility for the debts of its subsidiary through applying the piercing the corporate veil tool resulted in the following conclusions.

So despite the fact that the issue discussed in this article, i.e. bringing a parent company to responsibility for the debts of the subsidiary through applying the doctrine of piercing the corporate veil, has not yet received wide coverage, nor turned into the focal point of numerous scientific studies and disputes, it is sure to say that the matter is of great relevance.

The main criteria of the need to apply the PCV doctrine in bringing a parent company to responsibility for the debts of the subsidiary company must be control, economic dependence, unlawful actions and cause-and-effect relations between the actions of the parent company in respect of its subsidiary and the loss incurred by the latter.

However, the doctrine and the case law are not just limited to strict criteria, but provide for individual approach to each case which allows setting new criteria for applying the doctrine.

Moreover, it is obvious that in order to bring a parent company to responsibility for the debts of its subsidiary through the PCV doctrine, the

parent company must be proven to have issued binding instructions for the subsidiary not provided for by the agreement or the articles of association, following which had adverse affects and caused loss, and made fulfilling of the subsidiary's obligations impossible. This shows that the issue of instructions by a parent company to its subsidiary is hard to be proven, as they are usually verbal, not written.

As there is no list of unified criteria for applying the doctrine of piercing the corporate veil in bringing a parent company to responsibility for the debts of its subsidiary, it is necessary to clearly identify and standardize such criteria, with their further incorporation in legislation. Special attention should be paid to the need of laying down clear grounds for bringing a parent company to responsibility for the debts of its subsidiary. Notwithstanding the aforesaid, let us underline another important idea — the corporate veil, as a rule, may be lifted if the subsidiary company is the instrumentality used by the parent company to get benefits.

Therefore, foreign legal experts have been discussing the legal nature of the PCV doctrine for many years. They focus on the issue of reasoned/unreasoned application of the doctrine in respect of various legal relations giving rise to responsibility. Therefore, further research and recognition of this disputable, but at the same time relevant institute by Ukrainian scientists will allow giving up the general principle of limited liability, which, in its turn, will solve the existing problems and fill the gaps in the current legislation. Furthermore, Ukrainian law-makers will have to apply the fundamental principles of applying the piercing the corporate veil doctrine that have been elaborated in detail and introduced by foreign legal practitioners.

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Makhinchuk V. M. Responsibility of parent companies for the debts of their subsidiaries as a result of piercing the corporate veil

This article deals with the timely issue of a possibility of and need for the use of the doctrine of piercing the corporate veil in bringing a parent company to responsibility for the debts of its subsidiary. The author analyses the international case law in respect of the application of this doctrine and the most widely used approaches to piercing the corporate veil in the context of relations between a parent and a subsidiary company.

Key terms: corporate veil, piercing the corporate veil, parent company, subsidiary company