

# Liability of the Parent Company of MNEs for the Debts of Its Subsidiaries

Wenying Zhang<sup>1,\*</sup>

<sup>1</sup> Shanghai University of Political Science and Law, Shanghai, China

\* Corresponding Author Email: 18409090@masu.edu.cn

**Abstract.** In the context of today's global economic development environment, the most basic and widely adopted internal organizational structure of multinational companies, as the most important economic entities in the process of continuous expansion, is in the form of parent and subsidiary companies. Under this structure, the parent and subsidiary of a multinational corporation are legally separate legal persons, while in practice the subsidiary is often under the integrated control of the foreign parent company based on the global strategy. The contradiction between this form of law and physical control makes it highly likely that MNEs will pursue their global strategies while circumventing their legal responsibilities and infringing on the interests of subsidiaries, their creditors, and even the host country. Therefore, how to deny the independent legal personality of the subsidiary in a timely manner, so that the parent company of the multinational company can bear the debt liability of the subsidiary in a specific situation, deserves in-depth study. China has not made a limited principle exception to the issue of the liability of the parent and subsidiary of multinational companies under specific circumstances so in practice, some multinational companies maliciously take advantage of the gap in China's legal system to avoid liability. Therefore, through the in-depth discussion of the principle of responsibility and the comparative study of the time of various countries, China should formulate relevant legal systems in line with China's national conditions and the current world economic situation as soon as possible, so as to effectively regulate the behavior between the parent and subsidiary companies of multinational corporations and better protect the legitimate interests of multinational subsidiaries and their creditors in China.

**Keywords:** Parent and Subsidiary of MNEs, Liability for Debt, Lifting the Veil of Corporation.

## 1. Introduction

In the actual economic relations of multinational corporations, incidents of damage to the interests of subsidiaries and their creditors due to the parent company occur from time to time. The emergence of some well-known cases has prompted people to think deeply about this issue. The two cases cited here raise the issue of the liability of the parent company of a transnational corporation to its subsidiaries from different angles.

First, the infringement of a subsidiary set up by the parent company's wrong investment project is the case of the tragedy in Bhopal, the capital of the Indian state of Madhya Pradesh [1]. On December 3, 1984, a leak of metal cans stored in the factory warehouse of the U.S.-owned United Carbide India Co., Ltd. (the Indian subsidiary of the United Carbide Corporation of the United States) in Bhopal City killed more than 2,000 local residents, with 30,000 to 40,000 serious victims and 520,000 injured. Following the case, representatives of certain victims and the Government of India filed a lawsuit in the Federal Court of New York in respect of the compensation case for The United States Company, which was dismissed on the grounds that it was not an appropriate court. The Government of India filed a lawsuit with the Indian courts in September 1986. The plaintiff argued that the United Carbide Company, as the parent company, was responsible for the occurrence of this gas tragedy, because the Bhopal plant was designed by the parent company, the gas storage equipment of the factory was too poorly designed, and the emergency siren equipment installed by it in similar factories in the United States was not installed, and the nearby residents were not warned after the gas leak, and the people's right to know was not respected. And the storage gas as a highly toxic gas can only be stored in small quantities, some Western countries have long stopped producing and storing this highly toxic gas,

and the US parent company is still storing a large amount in the Bhopal plant despite the warning of the local subsidiary. Clearly, the U.S. parent company is fully responsible for this tragedy.

Second, the mistake of the parent company is the serious damage caused to the creditor by the bankruptcy of the subsidiary, taking the UK's *Multinational Gas and Petrochemical Company v. Multinational Gas and Petrochemical Limited-Service Company* as an example. In this case, MNNG was a joint venture jointly established by three major foreign oil companies, all of which were conducted outside the UK and whose directors resided abroad. Between 1973 and 1975, the directors made a lot of careless decisions on the orders of the shareholders of the parent company's oil company, and by 1978, the company had only the minimum assets and had to close down, causing significant damage to creditors, and the company's parent company did not file a settlement, so the subsidiary filed a debt lawsuit. The English court adopted the view of independent substance in the case. What about the liability of the parent company if, in this case, the company was not a joint venture but a sole proprietorship invested only by a foreign parent company, and the parent company placed the subsidiary under absolute control and the subsidiary had no autonomy over its own actions?

It can be seen that the issue of the debt liability of the parent company of a multinational company to its subsidiaries is also an important issue that must be solved by objective reality.

## **2. The theoretical discussion of the principle of responsibility**

### **2.1. Principle of Limited Liability**

The parent and subsidiaries of a multinational corporation generally form their own separate legal entities, while independent legal personality is usually associated with the principle of limited liability [2]. According to the principle of limited liability of legal persons, in internal relations, the liability of shareholders is limited to the amount of capital contribution, and externally, the responsibility is based on all the property of the company. As the cornerstone of modern corporate law, limited liability has long become a common feature of the company laws of various countries and naturally has also become a general liability rule between the parent and subsidiary companies of multinational corporations.

The value of the principle of limited liability in promoting economic development is self-evident. As Former Columbia University, President Barrett once pointed out: "The limited liability company is the greatest invention of our time, and its significance even exceeds the invention of the steam engine and electricity." According to many scholars, the value of the limited liability is fully reflected in the following aspects:

- (1) Reduce and transfer risks.
- (2) Encourage investment.
- (3) Promote the separation of ownership and management rights.
- (4) Enhanced the trading market.

However, with the development of society, the expansion of multinational corporations has intensified, and the legal goals they serve have continued to evolve, it can be obviously seen that an excellent legal system is a double-edged sword. While acknowledging the epoch-making significance of limited liability for the modern corporate system, it can be seen that it has its coherent shortcomings [3]. For example, the most famous issues that provide opportunities for controlling shareholders to abuse the legal personality of the company through sensible abuse of the legal personality of the company, unfairness towards creditors (including creditors of subsidiaries of multinational corporations), and avoidance of tort liability are the "Fluhof case in France", the "Massacre in Bhopal, the capital of Madhya Pradesh", and the "*Multinational Gas and Petrochemical Company v. Multinational Gas and Petrochemical Limited-Service Company*" in the United Kingdom.

## **2.2. Exceptions to limited liability in exceptional circumstances**

In practice, the most important way to make the parent company liable for the debts of its subsidiaries in exceptional circumstances is to lift the veil of the legal person on the basis of certain exceptions to the principle of limited liability [4].

"Lifting the Veil of Corporation" refers to a legal measure set up to prevent the abuse of the company's independent personality and protect the interests of the company's creditors and the public interest, deny the independent personality and limited liability of the company and the shareholders behind it with respect to specific facts in the specific legal relationship, and order the shareholders of the company (including natural person shareholders and legal person shareholders) to be directly responsible for the company's creditors or public interests, so as to achieve the requirements of fairness and justice.

Through the timely denial of the corporate legal personality in specific cases, the imbalance of corporate interest relations has been corrected after the fact, and the general abstract principle of limited liability has been maintained through the denial of individual-specific corporate legal personality, and the deviation caused by the independence of corporate legal personality and limited liability in practice has been corrected.

## **3. A comparative study of national practice**

The theoretical proof of the principle of the liability of the parent company of a multinational corporation for the debt of its subsidiaries has been correspondingly confirmed and tested in the practice of many countries [5]. These states, without exception, have adopted limited liability as a general principle, while at the same time taking "Lifting the Veil of Corporation" to make the parent company responsible for the debts of its subsidiaries in certain circumstances.

### **3.1. The practical application of "unveiling the veil of a legal person"**

In the jurisdiction of the court, in addition to the theoretical basis of the judgment, the more specific issue is to clarify the main elements constituting the liability of the parent company. In general, guided by the principle of "unveiling the legal person" in the United States, the court mainly considers the following factors when applying the unveiling rule: that is, undercapitalization, fraud, commingling of assets, failure to follow corporate formalities, and control [6].

#### **(1) Undercapitalization**

The significant capital shortage is one of the most important factors in determining corporate personality. If a company organizes the operation of a business without sufficient capital, it may be considered to use the corporate system to evade the responsibilities of individual shareholders.

The undercapitalization criterion requires a company to have sufficient sources of funds to carry out its business activities in order to cover losses that may occur in the course of its operations. In general, the appropriate amount of capital should be based on whether the amount of capital is sufficient to satisfy debts that may occur in the ordinary course of business of the company.

#### **(2) Fraud**

Fraud, in the case of denying the personality of the company, generally refers to the violation of public order and good customs, or the illegal behavior of violating laws and regulations. A corporate action may be considered fraudulent if it causes unfair harm to the creditors or minority shareholders of the subsidiary.

In the case of parent and subsidiary companies, common fraudulent behavior is mainly manifested as the parent company sets up one or more subsidiaries, and the company with the smallest amount of assets and the worst financial situation makes the most frequent transactions with a third party financially to bear the most debts, so as to achieve the purpose of debt evasion [7]. In addition, if the parent company allows the subsidiary to operate a higher risky and less profitable industry, or otherwise deprives the company of its assets, or transfers the assets to the parent company, etc.

#### **(3) Commingling of assets**

Difficulties in making clear distinctions between the asset relationships between parent and subsidiary companies, or being directly mixed in the accounts, can lead to the parent company treating the assets of subsidiaries as if they were themselves.

Asset commingling can easily lead to some wrongdoings of the parent company, such as concealing property, illegally transferring assets, and evading debts and liabilities.

(4) Failure to follow corporate formalities

This standard mainly refers to the fact that the company often does not perform its duties in regulations, such as not convening the board of directors or shareholders' meetings or not having detailed meeting records, or not establishing sound company books.

Non-compliance with appropriate corporate forms appears to be a formality issue that promotes compliance requirements for companies.

(5) Control

Excess control is one of the most appropriate criteria for dealing with parent liability issues within a parent company. The constituent elements of this criterion are: the parent company has completely dominating control over the operation of the subsidiary; the cause of the controlled act is that the parent company infringes on the subsidiary in order to obtain an improper advantage; the controlled act causes the result of damage to the creditor or shareholder, and the proximate causation of creditor's damage.

Overall, the use of the above factors and criteria has enabled the principle of "unveiling legal persons" to be effective in specific cases.

### **3.2. Direct provisions of the Companies Group Act**

#### **3.2.1 Germany - legislation on corporate groups**

(1) According to § 302 of the German Joint Stock Company, the parent company is obliged to make up for the annual losses of the subsidiary in the case of a contract between the parent company and the subsidiary in the event that it is linked to a contract such as a control contract or a surplus transfer. The subsidiary, therefore, does not show any net loss, and its creditors are indirectly protected.

(2) With regard to de facto corporate groups (i.e. parent and subsidiary are not interconnected through enterprise contracts, but are managed by other de facto factors, managed by the parent company), according to article 311 of the German Joint Stock Company Act, a controlling company that does not have a control contract may not use its influence to make the subordinate company a legal action against itself, or to the detriment of itself by not deciding or acting on measures. Otherwise, the controlling company and its responsible person shall be liable for damages. That is, the parent company is allowed to interfere with the practice of the subsidiary, but must be compensated for each individual and determined damage arising therefrom.

(3) For integration, i.e. the two companies do not become one, which is equivalent to the parent company holding all the equity of the subsidiary. The legal consequence is that, in addition to making up for the net loss, the parent company is directly responsible for all the debts of the subsidiary.

#### **3.2.2 Provisions of the French Bankruptcy Code**

Under French law, the effect of insolvency proceedings for subsidiaries may extend to the property of the parent company [8]. The parent company is legally regarded as a subsidiary in the "diligent as fact". Specifically, subsidiary insolvency proceedings and the effects of the parent company's property may occur when the assets of the subsidiary are disposed of as if they were the property of the parent;

#### **3.2.3 Provisions of EU law**

Under the proposed Directive 9 of EU Law, a group of companies may be formed by contract or unilateral declaration in respect of more than 90 percent of the ownership of the subsidiary, provided that the rights of minority shareholders and creditors of a subsidiary are protected under certain minimum standards.

Once the contract is formed, when the group is established, the subsidiary is subject to the management of the parent company, and the parent company acts for the benefit of the group, and in

exercising the management power, the parent company is liable for negligence that does not meet the standard of "prudent action" care. As long as the contract period expires, the subsidiary may require the parent company to compensate for any impairment it suffered during the contract period unless the parent company can prove that the reduction is not the result of its effects.

If there is no group, the protection of the subsidiary is more advantageous. If there is no group, the company must be managed entirely for the benefit of the subsidiary itself. Carpenters must be liable to the subsidiary for any damage arising from their influence on the subsidiary. Moreover, members of the governing body of the parent company also assume unlimited liability, together or individually, together with the parent company.

## **4. Reflections and suggestions for improving China's current legal system**

### **4.1. Current status and major issues of Chinese legislation**

First of all, according to China's Law on Sino-Foreign Equity Joint Ventures, the Law on Sino-Foreign Cooperative Joint Ventures, and the Law on Foreign-Funded Enterprises, the basic principles of China's three foreign-funded enterprise laws are: (1) when a foreign-invested enterprise has the conditions for a legal person and obtains legal personality, the foreign parent company only bears limited liability, and there is no other liability except for the payment of the capital contribution; (2) when the foreign-invested enterprise does not have the legal personality conditions, the parent company should be directly responsible for the debts of the enterprise.

Secondly, the three foreign-funded enterprise laws establish the principle of absolute limited liability, and the Civil Code also simply establishes a limited liability system for independent legal persons, but it leaves room for exceptions to limited liability in form, and in fact, there are no other supplementary provisions, so this space is useless.

Finally, in the legal regulation of the liability relationship between parent and subsidiary companies in China, some practices have broken through the traditional principle of limited liability, but the scope of application of these provisions is limited to the domestic parent and subsidiary companies, and the extraterritorial use of the liability of multinational parent and subsidiary companies still needs to be improved.

### **4.2. Suggestions for improving relevant legal systems in China**

#### **4.2.1 Recommendations for specific legal provisions**

In particular, exceptions to the following principle of limited liability may be provided:

(1) If the subsidiary is unable to pay off the debts of the creditor due to the false declaration of registered capital or false capital contribution, the parent company shall bear joint and several liabilities for the debts of the subsidiary [9].

(2) If the subsidiary withdraws its capital contribution and conceals its property liability, in addition to the subsidiary's responsibility to bear personal responsibility, if the parent company knows but does not prohibit or assist the subsidiary to commit the above acts, the parent company shall bear joint and several liabilities for the debts of the subsidiary.

(3) The parent company may sign a dominant contract with the subsidiary and directly exercise some of the powers that should have been exercised by the subsidiary. There should be clauses in the dominant contract that protect the other shareholders in the subsidiary. Where the parent company enters into a dominance contract with its subsidiary, it shall be jointly and severally liable for the debts of the subsidiary.

(4) The parent company uses its control and dominance over the subsidiary to carry out related party transactions, transfer funds, goods, real estate, and labor services, set up mortgages and guarantees, and bring irreparable losses to the subsidiary, and the parent company shall bear joint and several liabilities for the debts of the subsidiary [10].

(5) The parent company uses its dominant control position over the subsidiary to implement unified management of its subsidiary to achieve a degree of integration, and the independence of the subsidiary cannot be reflected in fact, and the parent company should bear joint and several liabilities for the debts of the subsidiary. Unless, of course, the parent company can demonstrate that such control did not result in the detriment of the interests of its subsidiaries.

(6) In the event of the bankruptcy of a subsidiary, the claims of the parent company shall be paid off after the other claims [11].

#### **4.2.2 Improvement of judicial practice**

With the continuous development of economic exchanges, new situations will continue to emerge on the legal issue of parent companies using subsidiaries to seek improper benefits, evade legal liabilities, and harm the interests of subsidiaries and their creditors [12]. Therefore, in addition to improving the exceptions to limited liability expressly provided for in the law, it is also necessary to improve them in judicial practice. We can use the principles of good faith, abuse of power and public order, and good customs to directly hold the parent company accountable. That is, in practice, the function of directly using the interpretation of legal principles and the function of supplementing legal loopholes.

Of course, when specifically allowing the parent company of a multinational company to bear the debt liability of the subsidiary, there must be sufficient reasons, otherwise, it will be detrimental to China's investment promotion.

### **5. Conclusions**

The legal provisions on the assumption of debt liabilities by the parent and subsidiary companies of a multinational corporation reflect not only the degree of legal integrity of a country but also the degree of development of a country's modern enterprise system and the corresponding level of legal development. Because the relevant provisions are actually the evolution of the principle of responsibility, the positive progress of the principle of limited liability self-denial.

This paper theoretically discusses the principle of limited liability and the exception of limited liability under special circumstances. On this basis, the "unveiling of legal persons" in the practice of various countries is analyzed and compared with the specific practices directly stipulated in the corporate group laws of various countries in the world. At the same time, it clarifies the current situation of China's legislation in this regard and makes suggestions based on the practices of other countries in the world.

It is hoped that these proposals will not only bring about the improvement of specific legal provisions, but also bring the level of development of China's relevant laws closer to the requirements of the WTO for the laws of various countries, create a standardized and reasonable legal environment for multinational companies invested in China, and promote the healthy and rapid development of China's modern enterprise system.

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