COMPARISON OF THE DOCTRINE OF "ENTERPRISE LIABILITY" IN U.S., GERMANY AND UZBEKISTAN

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Abstract

As a rule, a parent company and its subsidiary are district legal entities that are not liable for the obligations of each other. Even though limited liability protects a parent company from incurring debts of its subsidiary, nevertheless, there are exceptions to this principle that allow a parent company to be held liable for the debts and obligations of the subsidiary. Such exceptions can be applicable both to individual and corporate shareholders.

This thesis provides analysis of “enterprise liability” doctrines in the U.S., Germany and Uzbekistan, i.e. the rules existing in these jurisdictions on disregarding the limited liability of a parent company and holding it liable for the debts and obligations of its subsidiary are analyzed and compared. It also contains some proposals for further improvement of these rules in Uzbekistan.

In U.S. these rules which are known as “piercing the corporate veil” doctrine has been developed by court practice. In civil law countries like Germany and Uzbekistan rules that regulate situations when a parent company can be held liable for the actions of its subsidiary are of statutory nature and are contained in Codes and Acts. These approaches to parent-subsidiary liability differ with their sources, scope of application, however, they are all aimed at providing protection to the subsidiary’s creditors and other shareholders.

Introduction

Globalization, trade liberalization, economic growth provide a stimulus and space for the growth of business. As a result, businesses grow larger and give rise to establishment of various subsidiaries and other affiliated companies that are aimed at facilitating business and accommodating it to different challenges[1].

As a rule, a parent company and its subsidiary are distinct corporate entities that are not liable for the obligations of each other. Such important principles of corporate law as separate legal personality and limited liability protect a parent company from incurring liabilities of its subsidiaries[2].

Limited liability provides protection of a shareholder from being personally liable for debts and obligations of the entity and limits it only to the amount of the shareholder's investment[3]. It also limits the creditors' claims only to the assets of the entity and not of the personal assets of the shareholders[4]. Limited liability can offer various advantages[5]. By providing a shield to shareholders from incurring debts of the entities, it encourages investment in business[6]. Opposite to unlimited liability where a shareholder is usually involved in the operation of business so as to minimize the risks of incurring personal liability, limited liability allows to invest in multiple businesses without the need to be involved in operating each of them[7].

It is important to bear in mind that limited liability is not an absolute rule. Rules that regulate situations of disregarding the limited liability of a shareholder are known to many legal systems.

[1] *See* ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW, TEXT AND CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 678-80 (1st ed. 2010) (discussing the reasons of corporate groups' formation)
[2] *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW, A COMPARATIVE AND FUNCTIONAL APPROACH 5-11 (3d ed. 2017). *See also* CAHN & DONALD, *supra* note 1, at 9-13.
[3] Phillip Blumberg, *Limited Liability and Corporate Groups*, 11 J. Corp. L. 573, 574-75 (1986).
[4] KRAAKMAN ET AL., *supra* note 2, at 8.
[5] *See* Rolf Garcia-Gallont & Andrew J. Kilpinen, *If the Veil Doesn't Fit.. An Empirical Study of 30 Years of Piercing the Corporate Veil in the Age of the LLC*, 50 Wake Forest L. Rev. 1229, 1232-33 (2015) (presenting reasons that support limited liability principle).
[6] ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 37 (4th ed. 2013).
[7] KRAAKMAN ET AL., *supra* note 2, at 9.

These rules allow to disregard limited liability in certain circumstances and to shift the liability from the company to the shareholders. This is exceptional remedy and it is usually applicable in cases when a shareholder was actually responsible for the actions of the entity[8]. Therefore, these rules exist as "a safety valve"[9]. Such rules can be deemed to have twofold purpose. On one hand they protect the rights and interests of creditors and encourage shareholders not exploit the entity for their own purposes to the detriment of creditors, on the other hand, they provide corporations with idea how to eliminate risk of being exposed to liability especially when subsidiarization and investment in other business entities are extensive. These rules can be applicable both to individual and corporate shareholders. In this thesis, rules of "enterprise liability"[10], i.e. the rules disregarding limited liability of a parent company and holding it liable for the subsidiary debts and obligations are discussed.

The limited liability principle and rules regarding the exceptions to this principle have always been and still remain a very topical subject. Corporate law is in constant change and therefore, these rules also should be in line with these changes. Hence, there is always room for their discussion and analysis.

One of the best ways to analyze advantages and disadvantages of legal concepts are through comparison of how they function in different legal systems. This thesis aims to provide analysis of "enterprise liability" doctrines in the U.S., Germany and Uzbekistan, i.e. the rules existing in these jurisdictions on disregarding the limited liability of a parent company and holding it liable for the debts and obligations of its subsidiary will be analyzed and compared with the purpose of determining the problems and providing proposals for further improvement of these rules in Uzbekistan. Therefore, possible subsidiary questions in this regard would be what the place of

[8] RICHARD A. BOOTH & ROBERT W. HAMILTON, CORPORATIONS 231 (6th ed. 2014.).
[9] *See* Kurt A. Strasser, *Piercing the Veil in Corporate Groups*, 37 Conn. L. Rev. 637, 640 (2005).
[10]The term "enterprise liability" used for the purposes of this thesis should not be confused with the notion of "enterprise liability" under the enterprise theory which will be discussed in Chapter 1.

"enterprise liability" rules is in the legal system of these countries, their sources and scope of application.

In U.S. these rules which is known as "piercing the corporate veil" doctrine, has been developed by court practice[11]. In civil law countries like Germany and Uzbekistan rules that regulate situations when a parent company can be held liable for the actions of its subsidiary are of statutory nature and are contained in Codes and Acts[12]. In this regard, the comparison of common law "enterprise liability" with its counterpart in civil law, helpes to see their similarities and differences as well as how they operates in these jurisdictions.

There has been a lot of discussion about the concept of corporate veil piercing in the U.S. and Germany as well as comparative analysis of these two jurisdictions. This thesis includes in the analysis perspective of Uzbekistan regarding this issue.

The thesis consists of four chapters. Chapter 1 discusses the rules on "enterprise liability" in the U.S. The doctrine of piercing the corporate veil in the U.S. is applicable both to individual and corporate shareholders. It allows the limited liability of a parent company to be disregarded upon certain circumstances which are described in detail in this Chapter. In addition to this, as some scholars consider this concept inadequate to meet the reality of modern corporate groups, the Chapter provides some discussion on the liability under "enterprise theory" as an alternative to this concept. Chapter 2 is devoted to the "enterprise liability" rules in Germany. Compared to the U.S., in Germany rules applicable to corporate shareholders are different from those related to individual shareholders and provided for by *Konzernrecht*, which is the law of corporate groups. As the liability regime differs depending on the type of corporate groups, this chapter analyzes these types of corporate groups and liability regimes of such groups separately. Chapter 3 discusses the "enterprise liability" rules in Uzbekistan. Similar to Germany, these rules have statutory nature. They are mainly applicable in the situation of insolvency of the subsidiary and

[11] BOOTH & HAMILTON, *supra* note 8, at 231.
[12] *See* Carsten Alting, *Piercing the Corporate Veil in American and German Law - Liability of Individuals and Entities: A Comparative View*, 2 Tulsa J. Comp. & Int'l L. 187, 191 (1994).

allow imposition of a “subsidiary liability” on a parent company if the insolvency has been caused by a parent company. This chapter provides analysis of these rules and rules establishing parent-subsidiary relationship. In addition to comparative points made in first three chapters, comparison of the approaches of these jurisdictions is presented in Chapter 4. This Chapter also contains some proposals for further improvement of the “enterprise liability” rules in Uzbekistan.

Chapter 1. "Enterprise liability" in the U.S.

1.1. Introduction to "enterprise liability" in the U.S.

Corporate legal personality and limited liability are well-established principles of U.S. corporate law[13]. They insure that shareholders are not liable for the debts and obligations of the entity beyond their amount of investment in the entity and that the entity does not incur liability for its shareholders' personal debts and obligations[14]. The limited liability shield is an important consideration for the shareholders when they decide to make investment in business[15]. It might be viewed as a guarantee against the risk of losing their personal assets in case a business entity cannot meet its obligations[16].

However, limited liability is not an absolute rule and it can be disregarded in certain circumstances[17]. If a claimant is unable to receive fulfillment of the obligations owed to him by the legal entity, the claimant can ask the court to ignore the "limited liability shield" of this entity and to obtain the debt from personal assets of the shareholders[18]. This is known as the common law equitable doctrine of "piercing the corporate veil". It is applicable both to individual and corporate shareholders[19]. Inasmuch as this thesis discusses parent-subsidiary liability, the focus of this chapter is made on the veil piercing concept related to corporate shareholders.

This chapter discusses the concept of piercing the corporate veil in the U.S. There are different groups of cases within parent-subsidiary context that relates to "veil piercing" of other subsidiaries in a group of companies or a parent entity's shareholders, however, in this chapter

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13 Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036, 1039 (1991). *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 1-4 (1st ed. 1983) (discussing the development of these principles). *See also* Blumberg, *supra* note 3 (discussing the history and evolution of limited liability principle).
14 PINTO & BRANSON, *supra* note 6, at 37.
15 *Id.*
16 *See id.* at 40 (discussing the arguments regarding the need to reform the limited liability principle with respect to some corporate forms).
17 Garcia-Gallont & Kilpinen, *supra* note 5, at 1233 (citing Richmond McPherson & Nader Raja, Empirical Study, Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil). *See also* Thomson, *supra* note 13, at 1041; Alting, *supra* note 12, at 220.
18 John H. Matheson, *The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context,* 87 N.C. L. Rev. 1091, 1098 (2009).
19 Alting, *supra* note 12, at 191.

the discussion is only limited to piercing the corporate veil of a parent entity. This chapter also analyzes the "test" of two "veil piercing" concepts, which are referred to as "alter ego" doctrine and "instrumentality rule". As the requirements of the "veil piercing" test is crucial for understanding circumstances under which the court will pierce the corporate veil and impose obligations of a subsidiary on a parent company, each aspect of this test is analyzed separately. Lastly, opinions on "enterprise theory" as an alternative to traditional view on piercing the corporate veil are presented.

1.2. The concept of "piercing the corporate veil" and its application to parent-subsidiary context

The concept of "piercing the corporate veil" is an equitable doctrine that refers to the situation when a court disregards the limited liability and imposes upon a shareholder obligations of the entity[20]. It exists as a "safety valve" to avoid the adverse results that limited liability may create[21]. By disregarding the limited liability of a legal entity to avoid such results, "veil piercing" concept ensures the protection of the entity's creditors or other shareholders.

Notwithstanding all its advantages, this concept receives various comments for failing to state uniform and precise rules regarding when and under what circumstances the limited liability of a business entity can be disregarded[22]. As it has been pointed out by Phillip Blumberg, courts use different metaphors or epithets to define veil piercing, however, it does not contribute much to the understanding of the concept[23]. He argues that such metaphors are mere "conclusory terms" and they do not explain court's considerations and policies with respect to veil piercing and cannot help to predict the result of the future cases[24]. Others also argue that courts do not clarify

[20] Thompson, *supra* note 13, at 1036. *See also* Garcia-Gallont & Kilpinen, *supra* note 5, at 1233.
[21] Strasser, *supra* note 9, at 640.
[22] *See e.g.* 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 (1997) (discussing the problems regarding the application of this concept).
[23] BLUMBERG, *supra* note 13, at 8.
[24] *Id.*

the weight of each factor and the way how these factors interact when they decide the cases[25], and that tests employed by courts to establish elements of veil piercing are considered to be "vague and inconsistent"[26].

Nevertheless, as Robert Thomson summarizes some positive opinions, despite of various comments regarding the concept's drawbacks, the courts are correctly "getting" the idea behind this concept[27].

Different from Germany, in the U.S. "veil piercing" concept applicable to situations of individual shareholder liability also extends to liability of a parent company for its subsidiary's debts and obligations[28]. It is important to note that in the parent-subsidiary context different situations of "veil piercing" might arise[29]. Apart from piercing of the corporate veil of a parent entity itself, there is also "veil piercing" of a shareholder behind the parent entity[30]. It is argued that it is easier to pierce the corporate veil when the result pursued is a parent company itself and not the parent company's shareholders because of the easiness of shifting the assets among related entities[31]. In addition to this, there is also "sibling corporation settings", where the corporate veil of other subsidiaries is asked to be pierced and an example of such situations is "taxi cab" cases[32].

Another important issue to note is the application of "veil piercing" concept in the context of modern corporate group settings.

Corporate group settings nowadays are much more complex and involves "layers of subsidiaries", affiliated corporations and different subcontractors[33]. Therefore, the concepts of

[25] Matheson, *supra* note 18, at 1099.
[26] *Id.*
[27] Thomson, *supra* note 13, at 1037.
[28] Alting, *supra* note 12, at 220.
[29] *See* PINTO & BRANSON, *supra* note 6, at 58-70.
[30] *Id* at 61.
[31] *Id.*
[32] *Id.* at 63. *See also* BOOTH & HAMILTON, supra note 8, at 239.
[33] Meredith Dearborn, *Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups*, 97 Cal. L. Rev. 195, 208 (2009).

limited liability and "veil piercing" do not correspond to this reality of sophisticated corporate arrangements[34]. "Corporate formalities" certifying separate corporate existence of the entities can be easily observed by companies and, as a result, courts will not be able to disregard the limited liability as the requirements of the veil piercing test are not met[35].

The arguments challenging the application of "veil piercing" concept in parent-subsidiary context also stem from the idea that limited liability in such context is inappropriate. The reason is that limited liability is provided to the shareholders to encourage investment in business and in the parent-subsidiary relationship the situation is different[36]. As a rule, in such relationship a parent company acts as the sole shareholder and a provider of capital to the subsidiary[37]. In another words, the interests of individual shareholders and corporate shareholders in making investment in a business entity are not quite similar.

Kurt Strasser also expresses similar opinion on this matter. He points out that a parent company performs a different role and function compared to the individual shareholders[38]. He argues that creating a subsidiary is a part of the business strategy and a parent company cannot be considered as an "independent investor"[39]. According to his view, a parent company has a wide influence and despite all the corporate formalities possesses real control over a subsidiary and, therefore, within the corporate group setting different companies are fragments that together operate business and a parent company is the one that coordinates it[40].

1.3. The "veil piercing" test

Unlike in Germany and Uzbekistan, where the requirements with respect to imposition of liability on a parent entity for its subsidiary obligations are mainly established by the relevant

[34] *Id.* (citing Peter T. Muchlinski, Multinational Enterprises and the Law). *See also* Phillip Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 Del. J. Corp. L. 283, 287-88 (1990).
[35] Dearborn, *supra* note 33, at 208 (citing Phillip I. Blumberg, The Law of Corporate Groups).
[36] Matheson, *supra* note 18, at 1101 (citing Phillip I. Blumberg, Limited Liability and Corporate Groups).
[37] *Id.* (citing Phillip I. Blumberg, Limited Liability and Corporate Groups).
[38] Strasser, *supra* note 9, at 638-39.
[39] *Id.*
[40] *Id.*

provisions of law, in the U.S. the test of the veil piercing concept has been developed by case law[41].

As previously mentioned, there is no single and precise legal formula of "veil piercing" concept[42]. As a result of the absence of unanimous application of this concept, different "variations" of veil piercing concept came into existence[43]. Even though courts use different terms to define the situations when limited liability is disregarded, nevertheless, they all lead to the same result and serve the same purposes[44]. As it was pointed out by Blumberg "[o]n analysis, these terms [alter ego doctrine, instrumentality rule, the mere department doctrine, the identity theory and others] are "slightly different roads to the same destination" and are essentially interchangeable."[45]

Blumberg argues that two categories of exceptions lie behind piercing the corporate veil concept[46]. The first category relates to the situations when the courts come to a conclusion that parent and subsidiary corporations are not factually distinct corporate entities but have "common identity" and the second category, where the courts admit the separate existence of the entities but make attribution of actions of one to another based on "agency" theory[47]. In this thesis, focus is made only on the first category of exceptions.

Inasmuch as these "veil piercing" concepts generally impose similar requirements, which are the absence of separate corporate existence because of control or domination or unity of interest or ownership, the wrongful conduct leading to injustice or inequitable result[48] and, in some cases, a

[41] Alting, *supra* note 12, at 192-93.
[42] *Id.* at 193. *See also* Jonathan Macey, *Finding order in the morass: The three real justifications for piercing the corporate veil*, 100 Cornell L. Rev. 99, 100 (2014).
[43] *See* Alting, *supra* note 12, at 193-96 (discussing various theories of veil piercing).
[44] *Id.* at 193 (citing Elvin R. Latty, Subsidiaries and Affiliated Corporations).
[45] Blumberg, *supra* note 13, at 10 (footnotes omitted).
[46] *Id.* at 9.
[47] *Id.*
[48] *See* Strasser, *supra* note 9, at 640; Dearborn, *supra* note 33, at 203-204; Sandra K. Miller, *Piercing the corporate veil among affiliated companies in the European Community and in the U.S.: a comparative analysis of U.S., German, and U.K. veil-piercing approaches*, 36 American business law journal, 74, 88 (1998).

causal link between wrongful conduct and loss sustained[49], each of these requirements is analyzed separately.

1.3.1. The requirement of "absence of independent corporate existence"

The absence of factual separate corporate existence lies at the heart of "veil piercing" concepts. Both "alter ego" doctrine and "instrumentality rule" impose this requirement[50]. In "alter ego" doctrine it is a "unity of interests and ownership[51]" that erases the separate corporate existence, while in "instrumentality rule" the existence of "control and domination[52]" indicates the absence of independent corporate existence. The terms "alter ego" and "instrumentality rule" are used interchangeably[53].

As Blumberg states, since a parent company itself does not respect corporate separateness of its subsidiary, the court should not be expected to do that[54].

Courts use various factors or grounds to test the separate corporate existence in the case[55]. These factors upon which courts base their analysis are generally similar[56]. In *Van Dorn Co. v. Future Chemical and Oil Corp.*[57], for example, the court relied on the following factors to determine the scope of control that would allow the court to disregard the corporate identities – "(1) the failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own"[58].

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[49] Strasser, *supra* note 9, at 640. *See also* Phillip Blumberg, *The Transformation of Modern Corporation Law: The Law of Corporate Groups*, 37 Conn. L. Rev. 605, 612 (2005).
[50] *See* Strasser, *supra* note 9, at 640.
[51] William J. Rands, *Domination of a Subsidiary by a Parent*, 32 Ind. L. Rev. 421, 433(1999).
[52] *Id.* at 431 (citing Frederick J. Powell, Parent and Subsidiary Corporations).
[53] Miller, *supra* note 48, at 91. *See also* Rands, *supra* note 51, at 433.
[54] BLUMBERG, *supra* note 13, at 10.
[55] See PINTO & BRANSON, *supra* note 6, at 41-45 (discussing different grounds for veil piercing).
[56] *See* Gevurtz, *supra* note 22, at 857 (discussing drawbacks of "template approach").
[57] Van Dorn Co. v. Future Chemical and Oil Corp., 753 F.2d 565 (7th Cir. 1985).
[58] *Id.* at 570.

Blumberg considers the approach of relying on such factors to determine the separate corporate existence as very formalistic because as long as all formal requirements are met, there will be no veil piercing[59]. He argues that it does not solve the problem and does not reflect the reality[60].

In addition to this, Blumberg stresses that, as a rule, such factors as lack of subsidiary's essential business operations, utilization by a subsidiary of services provided by a parent company, high economic integration, realization of the output of a subsidiary exclusively to a parent company, dependence on the financial assistance of a parent company, interlocking directorate are not taken into account by courts despite their importance for establishing the lack of factual separateness between a parent and a subsidiary[61]. These factors are indisputably very important and indicative for establishing economic reality existing in parent-subsidiary relationship, however, the very nature of economic ties and connections between parent and subsidiary companies entails all these activities. If the court takes them into account, parent companies will be easily exposed to incurring their subsidiary's liabilities.

The application of the requirement of the absence of separate corporate existence due to "unity of interest and ownership", can be illustrated by *Van Dorn Co. v Future Chemical and Oil Corp.* case.

In this case, the appeal court used a two-prong test to check the trial court finding that two entities "Future" and "Sovereign of Illinois" were treated as a single corporate entity and therefore had to be jointly and severally liable for breach of contract before "Milton", the division of "Van Dorn"[62]. This test consists of two requirements: first, "unity of interest and ownership" that makes separate personalities of the entities no longer distinct and second, in case of adherence to separate existence of these entities, fraud would be sanctioned or injustice would

59 BLUMBERG, *supra* note 13, at 10.
60 *Id.* at 13.
61 *Id.* at 11-12.
62 *Van Dorn Co.*, 753 F.2d at 566-67.

be promoted[63]. Among the facts on which the appeal court relied to determine whether the requirements of the test has been met are the lack of due attention to corporate formalities such as shareholders' meetings, insiders treating these two entities as one and collectively referring to them as "the company", use of consolidated accounting statements, conclusion of numerous transactions between two entities[64]. Moreover, the court stressed the fact that while one of the entities has bought goods, they were actually used by the other entity[65]. The court was convinced that the shareholder and the director dominated both entities and intermingled them so as to turn them factually into one entity[66].

Indeed, the failure to observe corporate formalities, mixing the assets of one company with the assets of another company, leaving the company without assets do not correspond to the idea of separate legal personality of a business entity. Therefore, the formal separation of the entities should not be a tool to avoid liability.

Another important "veil piercing" concept is "instrumentality rule". Compared to the "alter ego" doctrine discussed earlier, the "instrumentality rule" consists of three requirements. They are (1) control and domination of the subsidiary by parent company turns it into a mere instrumentality, (2) through this control and domination fraud or injustice is perpetrated by parent company and (3) as a result of these elements unjust loss or injury are sustained by the complainant[67].

Control and domination are important indications of the absence of subsidiary's independent functioning[68]. It is important to note, that control is also a key element establishing existence of parent-subsidiary relationship under German and Uzbek law. Corporate separate personality and limited liability of the shareholders are based on the idea that a business entity is independent

[63] *Id.* at 569-70.
[64] *Id.* at 571.
[65] *Id.* at 572.
[66] *Id.*
[67] BLUMBERG, *supra* note 13, at 14; Rands, *supra* note 51, at 431.
[68] Gevurtz, *supra* note 22, at 862-66. *See* Alting, *supra* note 12, at 227-31 (discussing control and factors that indicate control).

and distinct from its shareholders and individuals operating it[69]. Therefore, if a corporate shareholder can interfere into entity's affairs depriving it of its independent existence and pursue its own interests via that entity, the entity de facto turns into a division of that shareholder[70]. However, the mere ability to exercise control is not a proof that there is a lack of separate corporate existence[71]. Parent companies are given wide powers in controlling its subsidiaries while still being exempted from liability[72]. However, the interference with the day-to-day management of a subsidiary by a parent company can be an indication of exercising control over the subsidiary[73].

In famous case *Lowendahl v. Baltimore and Ohio Railroad*[74], the instrumentality rule was formulated[75]. The trial court found the defendants "New York Transit and Terminal Co., Ltd." and "Baltimore and Ohio Railroad Company" liable for the amount of judgment which found transfer of business to "L. Van Bokkelen, Inc." illegal[76]. The trial court based its decision on the theory that "L. Van Bokkelen, Inc." was controlled and dominated by defendants that they also controlled that fraudulent transfer and therefore, "the Van Bokkelen corporation had no will or existence of its own, but was the mere dummy, instrumentality or department of defendants' own business"[77]. The appeal court, however, did not agree with the trial court and stated that control through ownership of stock and power to elect officers and directors of the entity would not per se predicate the liability[78]. The appeal court found "instrumentality rule" to be more practical and effective tool to disregard corporate immunity in cases when the equity requires it in order to "circumvent fraud or other legal wrong"[79]. The court stated that the following three requirements

[69] Thomson, *supra* note 13, at 1039.
[70] Alting, *supra* note 12, at 228.
[71] *Id.* at 230. *See also* Strasser, *supra* note 9, at 644.
[72] Alting, *supra* note 12, at 230
[73] *Id.* (citing Phillip I. Blumberg, The Law of Corporate Groups: Tort, Contract, and Other Common Law Problems in The Substantive Law of Parent and Subsidiary Corporations).
[74] Lowendahl v. Baltimore and Ohio Railroad, 287 N.Y.S. 62 (N.Y. App. Div. 1936).
[75] Alting, *supra* note 12, at 195.
[76] *Lowendahl*, 287 N.Y.S. at 146-47.
[77] *Id.* at 147.
[78] *Id.* at 154.
[79] *Id.* at 156.

must be present: 1) control in the form of complete domination as if corporate entity did not have "separate mind, will or existence of its own", 2) control has been used to commit fraud or wrong and 3) control and breach must cause the injury or loss to the person who complains[80]. Applying this test to the facts of the case, the appeal court concluded that the plaintiff did not prove that "Van Bokkelen, Inc." was instrumentality[81]. By referring to numerous facts of the case, the appeal court stated that the corporation was planned and organized by other person and that the corporation was conducting its own business independently[82]. Moreover, the court stressed that the plaintiff did not prove control by defendants at the time when the transaction took place[83]. Thus, the appeal court found that instrumentality rule requirements have not been met in this case.

The instrumentality rule was also criticized for not providing the solution to the problem and failing to provide guidance on the scope of domination and control that are necessary to trigger liability[84]. Moreover, it has been argued that the court in *Lowendahl* severely restricted the application of veil piercing concept by requiring the control to be in the form of "complete domination" which is a very high threshold[85].

It is important to mention Powell's checklist which contains a number of factors that the court might take into account when evaluating whether limited liability should be disregarded[86]. These factors can be grouped into three categories – factors related to control and domination, undercapitalization and disregarding of corporate formalities[87]. Analysis of case by checklist is considered as being very limited and resulting in fragmentation of different factors and ignoring "the totality of the interrelationship of the parent and the subsidiary" as this way of analysis can

[80] *Id.* at 157.
[81] *Id.* at 158.
[82] *Id.* at 158-59.
[83] *Id.* at 159.
[84] BLUMBERG, *supra* note 13, at 14.
[85] *Id.*
[86] *Id.* at 16. *See also* Rands, *supra* note 51, at 433-36.
[87] Alting, *supra* note 12, at 195-96.

not show the economic reality of the business unity of both a parent entity and a subsidiary entity[88].

As Franklin A. Gevurtz states the "template approach" has several drawbacks[89]. He argues that in listing the facts from other cases without considering why they should lead to veil piercing has little significance[90]. The relevance of facts largely depends on the circumstances of individual case, and such "template approach" raises various questions such as whether all factors must be present or only some of them[91].

1.3.2. The requirements of "preventing of fraud or injustice" and "causal link"

Another requirement of the veil piercing test is the presence of "wrongful conduct" or as it is alternatively labeled by courts "fraudulent" or "inequitable" conduct[92]. Along with disregarding of separate corporate existence of the entities, there also has to be presence of an inequitable result in case the liability is not imposed upon a shareholder[93]. A study by Peter Oh of 3 000 cases related to veil piercing showed that "fraud claims" are "the best predicator of a piercing decision"[94].

The scope of this requirement is also not clearly defined and, therefore, the result of the case depends on whether the court will consider the facts of the case as sufficient to trigger veil piercing concept[95]. It is important to note that this requirement can be used by courts either to allow limited liability to be disregarded by treating this requirement as a mere formality in such

[88] BLUMBERG, *supra* note 13, at 20.
[89] Gevurtz, *supra* note 22, at 856-58.
[90] *Id.*
[91] *Id.*
[92] Strasser, *supra* note 9, at 640. *See also* Blumberg, *supra* note 49, at 612; Gevurtz, *supra* note 22, at 862.
[93] Alting, *supra* note 12, at 231. *See also* Macey, *supra* note 42, at 101 (discussing policy objectives of veil piercing and preventing fraud as one of it).
[94] Macey, *supra* note 42, at 112 (citing Peter B. Oh, Veil-Piercing).
[95] *See* Strasser, *supra* note 9, at 641.

cases as, for example, where even breach of contract can be regarded as wrongful conduct, or as a serious obstacle for the relief sought[96].

As Carlston Alting summarizes, factors indicating "wrongful conduct" are manipulation of finances of the subsidiary, its undercapitalization or misrepresentation[97]. The examples of such factors can be establishing the entity to avoid the payment of creditors, representation of the entity as being a department of the parent company or that another entity assumed the obligations[98].

In *Sea-Land Services v Pepper Source*[99], as the plaintiff could not recover the judgment against "Pepper Source", it asked the court to pierce the veil and hold Gerald J. Marchese, the owner of defendant companies, liable along with these defendant companies for amount in the judgment against "Pepper Source"[100]. By applying the test employed in *Van Dorn*, the district court held the defendants jointly liable[101]. The appeal court analyzed the correctness of the trial court's order. The appeal court agreed with the court conclusion that the first part of the *Van Dorn* test had been met[102]. Marchese was the sole shareholder of almost all of these companies, there was never any shareholders' meetings held, Marchese run all the companies in one office, he easily transferred money from one corporation to another, he even used the corporate account for his personal needs[103]. These facts convinced the appeal court that Marchese failed to respect the separate corporate existence of those entities. Nevertheless, the appeal court concluded that the plaintiff failed to prove and meet the second requirement of the test, i.e. to prove that respecting separate corporate existence will sanction fraud or promote injustice[104]. Sea-Land's argument with respect to this requirement was that since it could not obtain "judicially-imposed recovery",

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[96] *Id.* (citing Phillip I. Blumberg, Kurt A. Strasser, Nicholas L. Georgakopoulos, & Eric J. Gouvin, Blumberg on Corporate Groups).
[97] Alting, *supra* note 12, at 231.
[98] Miller, *supra* note 48, at 93.
[99] Sea-Land Services v. Pepper Source, 941 F.2d 519 (7th Cir. 1991).
[100] *Id.* at 519.
[101] *Id.* at 520.
[102] *Id.* at 522.
[103] *Id.* at 521.
[104] *Id.* at 524-25.

the adherence to the separate corporate existence would promote injustice[105]. However, the appeal court was not convinced and stated that it did not meet the threshold of the test[106]. Court stated that inability to obtain this "judicially-imposed recovery" is nearly always present in veil-piercing cases, and if to allow plaintiffs to rely on this fact to meet the second part of the test, it could undermine the *Van Dorn* test and turn it basically into one-requirement test[107]. The court went on to state that such wrong can be proven by presenting evidence that perhaps defendant used such corporate facades in order to avoid responsibilities from creditors, or there was unjust enrichment of other defendant corporations[108]. Thus, in order to rely on veil piercing, plaintiff had to prove any of these facts.

In *Van Dorn*[109], the court's conclusion is different. The court concluded that "Future" was intentionally left without assets[110]. To leave the entity without any assets, knowing that "Milton" was the sole creditor and, thus, placing the creditor in unfavorable position, was a convincing factor for the court that the second part of the test has been met[111]. Moreover, facts suggested that the owner of these entities created a situation where "Future" undertook all liabilities while being left without assets, but the benefits of the transaction received "Sovereign of Illinois"[112]. The court stated that this was sufficient to meet the second part of the test[113].

Compared to the alter ego doctrine, the instrumentality rule explicitly requires a causal link between wrongful conduct and loss or damage sustained[114]. Even though causal link might not be explicitly required, nevertheless, courts that apply alter ego concept require to demonstrate the

[105] *Id.* at 524.
[106] *Id.*
[107] *Id.*.
[108] *Id.* at 525.
[109] The facts of the case are discussed in previous subchapter.
[110] *Van Dorn Co.* 753 F.2d at 572.
[111] *Id.*
[112] *Id.*
[113] *Id.* at 572-73.
[114] Gevurtz, *supra* note 22, at 862.

causal link as part of the case if it is an issue[115]. Some courts state that causal link is not proved if the subsidiary can itself satisfy the judgment[116].

1.4. The enterprise theory as an alternative to "veil piercing" concept

Entity principle strongly upholds the idea of separate corporate legal personality regardless of the relationships of the entity with affiliated companies[117] and the limited liability of the entity[118]. As it was previously discussed, the limited liability can be disregarded in exceptional situations, where shareholder did not pay due regard to corporate separate existence and this has given rise to some unfair and inequitable result.

As stated by Blumberg, the idea that each entity in a corporate group should be considered as a separate legal entity unaffected by operating within such groups is not realistic. Instead, he argues that liability of a parent entity and of other corporate group members for the obligations of the entity within such group should be considered by practitioners and scholars[119].

Adolf Berle, a proponent of the enterprise theory, believes that in corporate group settings all affiliated enterprises have a common purpose, therefore, they have to be treated from an economic perspective as "a united whole", and a fiction of separate legal personality becomes only a legal formalism[120]. Therefore, Berle proposes "enterprise liability", the concept of imposing liability on a parent company for the actions of its subsidiaries if the corporate enterprise benefited as a whole[121]. In other words, Berle differentiates between the economic reality and the legal formalism within the corporate group settings and argues that since the

115 Strasser, *supra* note 22, at 641 (citing Phillip I. Blumberg, Kurt A. Strasser, Nicholas L. Georgakopoulos, & Eric J. Gouvin, Blumberg on Corporate Groups).
116 *Id.*
117 Blumberg, *supra* note 34, at 285.
118 Dearborn, *supra* note 33, at 198.
119 Blumberg, *supra* note 34, at 287-88.
120 Dearborn, *supra* note 33, at 199-200.
121 *Id.* at 200.

group as a whole can benefit from the action of a subsidiary, a parent company should bear liability[122].

As opposed to the traditional "veil piercing" concept, this theory requires the determination only of "single business entity" factor, i.e. that because of the parent's domination over the subsidiary's business operations, the latter does not have its separate existence[123].

It has been argued that enterprise liability can deal with the problems that the principle of limited liability creates in a more efficient way as compared to the traditional approach that heavily relies on legal formalities, because "enterprise liability seeks to marry legal and economic realities"[124]. Moreover, enterprise liability could also allow "horizontal piecing" where a claimant can recover from the sister subsidiary[125].

Although enterprise liability better accommodates economic reality in a parent-subsidiary context, courts are reluctant to give it the full affect[126]. Despite its benefits, enterprise liability is not a rule in the U.S.[127] For now, it exists in different spheres of law, where legislature and courts seek to protect regulatory goals of high importance that could otherwise be undermined by the principle of separate corporate personality[128].

1.5. Conclusion

The concept of "piercing the corporate veil" which allows a parent company to be held liable for the obligations of its subsidiary in the U.S. has been created by case law. The veil piercing rules are very important for affording protection of creditor's interests and for ensuring that the limited liability is not used in any improper way by legal entities. However, the main drawback of the concept is the absence of precise and uniform requirements regarding its application. Therefore,

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[122] Adolf A. Berle, *The Theory of Enterprise Entity*, 47 Colum. L. Rev. 343, 344 (1947).
[123] Matheson, *supra* note 18, at 1103.
[124] Dearborn, *supra* note 33, at 210.
[125] *Id.* at 211
[126] *See id.* at 214.
[127] *Id.* at 245.
[128] *Id.*

whether a particular situation can be deemed to reach the "veil piercing" threshold depends on interpretation of the rules by the court. This leads to uncertainty and to a lack of uniformity. The veil piercing test mainly requires two elements in order to pierce the limited liability of a parent company. They are the absence of factual independent existence of a subsidiary and wrongful conduct or inequitable result if the corporate veil would not be pieced. As to the application of veil piercing concept in corporate group settings where affiliated entities are closely related and operated as one single enterprise, it has been argued that veil piercing concept is considered as failing to adjust to the realities of such groups. Nevertheless, veil piercing concept generally remains to be a main rule.

Chapter 2. “Enterprise liability” in Germany

2.1. Introduction to “enterprise liability” in Germany

German corporate law is highly regulated and its many provisions are of mandatory nature[129]. One of the distinct features of corporate law in Germany is the contribution of courts to the development of legal rules[130]. In the sphere of company law, German courts do not “robotically” apply the law, but instead create doctrines that go beyond the statutory rules[131].

German law, as many other legal systems, recognizes the concepts of corporate legal personality and limited liability[132]. For instance, such corporate forms as *Aktiengesellschaft* (hereinafter “AG”) which is a stock corporation and *Gesellschaft mit beschränkter Haftung* (hereinafter “GmbH”) which is a limited liability company, offer limited liability to the owners[133]. German law, similar to the U.S., recognizes situations when the limited liability of a company can be disregarded. *Durchgriffshaftung* is the term that refers to case law with respect to situations when limited liability of a company is disregarded[134]. The issue of liability of a parent company within affiliated companies is regulated by statutory norms and *Konzernrecht* or the law of corporate groups is the main source where these provisions are provided[135]. This chapter focuses on the relevant provisions of *Konzernrecht* regulating parent-subsidiary relationship and liability.

The chapter starts with the discussion of *Konzernrecht*, its source as well as types of affiliation it envisages. In this chapter focus is made on such type of affiliation as corporate groups. The chapter provides analysis of three types of corporate groups and liability regime that they entail. These corporate groups can be divided into contractual and factual. In contractual corporate

[129] CAHN & DONALD, *supra* note 1, at 13-14.
[130] *See* NIGEL FOSTER & SATISH SULE, GERMAN LEGAL SYSTEM AND LAWS 52-55 (4TH ed. 2010) (discussing “judicial lawmaking” in Germany).
[131] *See* CAHN & DONALD, *supra* note 1, at 15 (discussing legal personality and liability types of corporations and partnerships).
[132] INTRODUCTION TO GERMAN LAW (JOACHIM ZEKOLL & MATHIAS REIMANN eds., 2005), at 144-45.
[133] *See* FOSTER & SULE, *supra* note 130, at 551-65 (providing overview of these two corporate forms).
[134] Alting, *supra* note 12, at 190.
[135] *Id.* at 191. *See also* FOSTER & SULE, *supra* note 130, at 566-67.

group setting a parent entity assumes the liabilities of the subsidiary, while in factual corporate group settings a parent entity's interference and harm to a subsidiary should be established in order to hold a parent entity liable. For better understanding of legal basis of each group and the scope of liability of a parent entity in such groups, these groups are discussed separately.

2.2. German *Konzernrecht*

German *Konzernrecht* is known as the law governing groups of companies[136]. As stated by Sandra Miller, compared to the U.S and the U.K., in Germany corporate law provides comprehensive regulation related to the rights and obligations of separate entities comprising a corporate group[137]. Indeed, in comparison with the U.S., where corporate law does not provide such extensive regulation of corporate groups, German corporate law significantly differs in this regard. German law has elaborated extensive rules regulating corporate groups that are codified in Stock Corporation Act *Aktiengesetz*[138] (hereinafter "AktG")[139]. This law balances between the interests of the controlled and controlling company and primarily focuses on the protection of minority shareholders and of creditors[140]. Thus, such issues as regulation of parent-subsidiary relationship, protection of creditors' interests and imposition of liability on a parent company that are important for the analysis of "enterprise liability" in Germany are primarily regulated by *Konzernrecht*.

General definitions regarding affiliation, control, group of companies that are contained in AktG apply not only to AG but to all entities[141]. However other detailed provisions of AktG including those regulating the consequences of control relationship only apply to controlled enterprises in

[136] GERHARD WIRTH ET AL., CORPORATE LAW IN GERMANY 207 (2nd ed. 2010).
[137] Miller, *supra* note 48, at 95.
[138] *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept.6, 1965, as amended, translation provided in WIRTH ET AL., *supra* note 136, at 294-558 (Ger.).
[139] Alexander Scheuch, *Konzernrecht: an overview of the German regulation of corporate groups and resulting liability issues*, 13 European Company Law, 191, 191 (2016). *See also* ZEKOLL & REIMANN, *supra* note 132, at 155-56.
[140] WIRTH ET AL., *supra* note 136, at 207.
[141] *Id.*

the form of AG or "partnership limited by shares" (KGaA)[142]. AktG provides for different types of affiliation between enterprises. These provisions are compared to the ladder with three "rungs", as meeting the requirement of each "rung" allows to rise to the next category[143]. One of the forms of affiliation is a majority ownership where one enterprise holds majority of capital or of voting rights in another entity[144]. There is also such form of affiliation as controlled enterprises where one enterprise exercises "direct or indirect controlling influence" over another[145]. Pursuant to Section 17 (2) of AktG, "it is assumed that the majority-held enterprise is controlled by the enterprise having the majority holding therein"[146]. In addition to this, there is also such form of affiliation as groups where one enterprise subjects other controlled enterprise(s) to a "uniform direction"[147].

This thesis focuses on enterprise liability within such form of affiliation as groups. Relevant provisions regulating its legal consequences can provide better understanding of the position of German corporate law with respect to the issue of parent-subsidiary liability.

Some estimates suggest that 75% of AG and 50% of GmbH in Germany are members of corporate groups.[148] As it was mentioned earlier, AktG is not applicable with respect to the controlled enterprises in the form of GmbH. And *GmbH-Gezets* (Limited Liability Company Act) does not contain rules regulating corporate groups[149]. Nevertheless, since such corporate form as GmbH plays significant role in groups, there are rules created by case law that are applicable to so-called *qualified de facto corporate groups* where controlled enterprise is usually in the form of GmbH[150].

[142] *Id.*
[143] Scheuch, *supra* note 139, at 192.
[144] *Id.*
[145] *Id.*.
[146] *See* AktG § 17, *translated in* supra 136.
[147] Scheuch, *supra* note 139, at 192.
[148] *Id.* at 191 (citing Volker Emmerich & Mathias Habersack, Konzernrecht).
[149] *Id.*
[150] René Reich-Graefe, *Changing paradigms: the liability of corporate groups in Germany,* 37 Conn. L. Rev. 785, 794-95 (2005).

As it will be discussed later in more details, AktG regulates two types of corporate groups: *de facto Konzern*, when majority ownership or control lead to creation of group of companies, and *contractual Konzern*, when a group of companies is created by concluding enterprise agreement[151]. The liability regime of the parent company depends on the type of corporate group. Therefore, liability of a parent company for its subsidiary is analyzed separately within contractual, factual and qualified de facto corporate groups.

2.3. Parent-subsidiary relationship and liability issues in contractual Konzern

Contractual konzern is formed by the agreement between controlling enterprise and one or several controlled enterprises[152]. According to Section 291 (1) of AktG "enterprise agreements are contracts by way of which a stock corporation or a partnership limited by shares transfers the management of such company to another enterprise (domination agreement) or undertakes to transfer its entire profits to another enterprise (profit transfer agreement)"[153]. In order to enter into such agreements, both controlled and controlling enterprises must fulfill certain requirements prescribed by law, such as, for example, approval by shareholders, reporting, auditing, registration and etc[154]. Thus, domination and profit transfer agreements can be a basis for creation of parent-subsidiary relationship between controlled and controlling enterprises. As such relationships are regulated directly by the agreement, they can be viewed as more predictable for the parties.

Transfer of management which the domination agreement allows means that controlled enterprise is under the "direction" of the controlling enterprise[155]. Section 308 of AktG which is called "power of direction" permits controlling enterprise "to issue instructions to the management board of controlled enterprise concerning management of the company"[156].

[151] *See* ZEKOLL & REIMANN, *supra* note 132, at 155-56.
[152] Miller, *supra* note 48, at 101.
[153] *See* AktG § 291, *translated in* supra 136.
[154] *See* Scheuch, *supra* note 139, at 193 (discussing requirements regarding conclusion of such agreements).
[155]WIRTH ET AL., *supra* note 136, at 211.
[156] *See* AktG § 308, *translated in* supra 136.

Moreover, “unless provided otherwise in the agreement, these instructions could be disadvantageous for the controlled enterprise in cases when they are issued in the interests of the controlling enterprise or enterprises in the same group”[157]. From the controlled enterprise’s side, pursuant to Section 308 (2) of AktG “the management board is obligated to heed the instructions issued by the controlling enterprise”[158]. However, this provision also stipulates that “it is not entitled to refuse to heed instructions which it believes are not in the interests of the controlling enterprise or enterprises in the same groups as the company and the controlling enterprise, unless it is apparent that the instructions do not serve such interests”[159]. Limitations to the issuance of the instructions extend to illegal measures and measures that create risk to the existence of the controlled enterprise[160]. Thus, in a case of *contractual Konzern*, a parent company can exercise control over subsidiary, however, it has to be done for the interests of the group as a whole and should not endanger the existence of the subsidiary[161].

Domination agreement allows business entity to subject itself to the control of other entity and to remain a separate corporate entity. This contract-based control relationship has advantages to the business entities as they are based on mutual consent and directly regulated by the provisions of the agreement.

As to the profit transfer agreement, in such an agreement a business entity provides its “entire balance sheet profit” to another entity and this agreement is usually concluded when the entity receiving the profits already exercises control over it[162].

The liability regime applicable in case of a *contractual Konzern* is of hybrid nature, which includes both “statutory-contractual” bases that affect the limited liability of the controlling

[157] *See id.*
[158] *See id.*
[159] *See id.*
[160] WIRTH ET AL., *supra* note 136, at 211; Scheuch, *supra* note 139, at 194.
[161] Reich-Graefe, *supra* note 150, at 789.
[162] WIRTH ET AL., *supra* note 136, at 211.

enterprise[163]. Parent company waives the limited liability with respect to the shareholding of the subsidiary by concluding such agreement[164]. By entering into such agreements, a parent company agrees to assume the liabilities of the subsidiary for a consideration of obtaining power to control and direct its management or transfer of profits. While being under the direction of a parent entity and fulfilling instructions that could be disadvantageous to the subsidiary, it can incur liabilities and, assumption of these losses by a parent entity seems equitable and corresponds to the principle of parties' equality of interests.

In light of the nature of rights that the controlling enterprise obtain due to such agreements and ability to exercise very broad powers with respect to the management of the controlled enterprise, the law provides certain rules that are aimed at protecting interests of the controlled enterprise and its creditors. The purpose of Sections 302 and 303 of AktG is to protect controlled enterprises and its creditors[165]. The main way of ensuring the interest of controlled enterprise to be protected is assumption of losses by the controlling enterprise. According to Section 302 of AktG "in the case of a domination or profit transfer agreement, the other party to the contract shall compensate for any other annual net loss occurring during the term of the agreement"[166]. It is important to note that it does not matter whether the controlling enterprise has caused the loss[167]. This liability is incurred even if there is no link between the losses of controlled enterprise and actual control that has been exercised by the controlling enterprise[168]. Specifically with respect to creditors, if the agreement ends Section 303 of AktG envisages the obligation of the party to provide security to creditors of the company with the claims that arose before such termination[169].

[163] Reich-Graefe, *supra* note 150, at 789.
[164] *Id*.
[165] Scheuch, *supra* note 139, at 194.
[166] *See* AktG § 302, *translated in* supra 136.
[167] Scheuch, *supra* note 139, at 195.
[168] Reich-Graefe, *supra* note 150, at 789.
[169] *See* AktG § 303, *translated in* supra 136.

This range of protective measures is important for the subsidiary, its shareholders and creditors. By voluntarily assuming such obligations on the basis of the agreement, a parent company ensures that the subsidiary's creditors will be able to receive satisfaction of their claims. It means that the creditor of subsidiary can turn into creditor of *Konzern*[170]. Thus, even though subsidiary's creditors might not have direct claim against parent company[171], nevertheless the position of subsidiary's creditors is secured in case of *contractual Konzern*.

As it concerns the controlled enterprise in the form of GmbH, there is no provision regulating it, however, domination agreement with GmbH can regarded as equally legal[172]. The liability of a parent company will follow the same rules applicable to AG[173].

2.4. Parent-subsidiary relationship and liability issues in *factual Konzern*

Another category of corporate groups recognized by German law is *de facto Konzern* or *factual Konzern*. As compared to the *contractual Konzern*, in *factual Konzern* there is no enterprise agreement between controlling and controlled enterprises regulating parent-subsidiary relationship[174]. In *factual Konzern* these relationships are rather based on the mere fact of existence of corporate group and control[175]. According to Section 18 (1) of AktG "if a controlling enterprise and one or more controlled enterprises are under the common direction of the controlling enterprise, they shall form a group, with the individual enterprises constituting groups enterprises"[176].

Thus, the existence of control relationships together with exercising by parent company of common direction would certify existence of *factual Konzern*. The statutorily recognized presumption that majority ownership entails control, implies that majority ownership usually

[170] Alting, *supra* note 12, at 237.
[171] *Id.*
[172] *Id.*
[173] *Id.*
[174] Reich-Graefe, *supra* note 150, at 790.
[175] Miller, *supra* note 48, at 104.
[176] *See* AktG § 18, *translated in* supra 136.

indicate creation of *factual Konzern*[177]. This presumption is based on the idea that there is "a lack of independence" of the majority-held company[178]. Another significant element necessary for the existence of *factual Konzern* is being under common direction of the parent entity. AktG does not provide a definition of this term. Presumably, this term means a situation when controlling enterprise establishes and realizes an overall policy or concept for the whole group in important areas of management[179]. In another words, it refers to situations of unified and centralized management, where parent and subsidiary entities are operated as a single enterprise[180].

Subjecting a business entity to control and centralized direction by another entity strongly indicates the existence of a parent-subsidiary relationship between these entities. It is important to note, that in case of *factual Konzern* similar to the U.S. approach, control or operation of entities as a single enterprise is essential for determining the affiliation and existence of a parent-subsidiary relationship.

Liability regime applicable to *factual Konzern* is different. If in the case of *contractual Konzern*, the parent company has to compensate all losses no matter whether they were caused by parent company's interference, in *factual Konzern* the liability of a parent company is not that extensive[181]. Section 311 of AktG is central with respect to the liability of a parent company and it states that "if no domination agreement exists, a controlling enterprise may not exploit its influence in order to cause a controlled stock corporation or partnership limited by shares to effect the transaction which is detrimental to itself"[182]. In case a particular interference is detrimental or disadvantageous to the subsidiary, the latter has to compensate for the damages sustained by the subsidiary and related to such interference[183]. According to Section 312 of AktG "subsidiary's management board has to draw up a report on relations within affiliated group,

[177] WIRTH ET AL., *supra* note 136, at 210.
[178] Reich-Graefe, *supra* note 150, at 790.
[179] WIRTH ET AL., *supra* note 136, at 210.
[180] Reich-Graefe, *supra* note 150, at 790.
[181] Miller, *supra* note 48, at 105.
[182] *See* AktG § 311, *translated in* supra 136.
[183] Reich-Graefe, *supra* note 150, at 792.

legal transactions as well as measures taken or refrained from taking at the request or in the interest of such enterprises"[184]. Based on these provisions, in case of *factual Konzern*, it would be difficult to impose the liability of subsidiary on a parent company.

Since there is no enterprise agreement directly stipulating the rights of the controlled enterprise to exercise control, in case of *factual Konzern* court in order to justify liability of a parent company should determine whether the control exercised with respect to a subsidiary was "sufficiently tight and disadvantageous"[185]. Therefore, imposition of liability requires fact-based analysis[186]. The burden of proof of detrimental interference would be on controlled enterprise[187]. In case of *de facto Konzern*, only subsidiary is entitled to claim for damages against parent company that resulted from a detrimental transaction and creditors can only "assert the debtor entity's claim"[188].

René Reich-Graefe compares enterprise liability in de facto corporate groups with the U.S. veil piercing concept and finds it similar[189]. He argues that compared to very broad liability in case of *contractual Konzern*, liability in *factual Konzern* is focused on the separate cases of interference by parent company, where disregard of the separate existence of the subsidiary also followed by "wrongful conduct" of parent company that creates harm for the subsidiary[190]. Moreover, there has to be causal link between the parent company's detrimental measure and subsidiary's losses[191]. Thus, in his opinion the approach regarding the liability of a parent company in *de facto Konzern* that requires the existence of centralized management, presence of wrongful conduct and causal link, is comparable with the veil piercing test[192].

[184] *See* AktG § 312, *translated in* supra 136.
[185] Alting, *supra* note 12, at 238.
[186] Reich-Graefe, *supra* note 150, at 791.
[187] Alting, *supra* note 12, at 238.
[188]*Id.*
[189] Reich-Graefe, *supra* note 150, at 791.
[190] *Id.*
[191] *Id.*
[192] *Id.*

Factual Konzern is viewed as ineffective because it is difficult to prove the specific damages and disadvantage sustained by a subsidiary due to a parent entity's interference[193]. As rightly pointed out, in practice *factual Konzern* can be comprised of highly interrelated corporate entities, and therefore, it might be difficult for the subsidiary to point out a single interference as the direct cause of particular damage[194]. Although there is a statutory liability of the parent company to its subsidiaries in *factual Konzern*, in practice it deems very difficult to establish it because it requires evidence of detrimental interference that can difficult to obtain for a shareholder or a creditor of the subsidiary[195]. Therefore, it is suggested to shift the burden of proof from the subsidiary to the parent enterprise[196].

2.5. Parent-subsidiary relationship and liability issues in *qualified de facto Konzern*

This type of corporate group is distinct from those discussed earlier as it has been created by case law[197]. Entities in the form of GmbH has been used extensively by German and foreign corporate groups for the purposes of arranging their business in Germany[198]. Since groups with GmbH as a subsidiary were left outside of statutory regulation with respect to liability issues, German judiciary developed so-called *"qualified de facto Konzern"* doctrine.[199] AG can be a subsidiary in *qualified de facto Konzern*, however due to independence of the board of directors from shareholders' instructions, this might have little practical relevance[200]. Therefore, GmbH rather than AG will be a dominated entity in *qualified de facto Konzern* [201].

[193] *See* Alting, *supra* note 12, at 238; Miller, *supra* note 48, at 105; Reich-Graefe, *supra* note 150, at 792.
[194] Reich-Graefe, *supra note 150*, at 792.
[195] Alting, *supra* note 12, at 240-41.
[196] *Id.* at 241 (citing Heinz-Dieter Assmann, Gldubigerschutz im fakrischen GmbH-Konzem durch richterliche Rechtsfortbildung).
[197] Miller, *supra* note 48, at 105.
[198] Reich-Graefe, *supra* note 150, at 794-95.
[199] *Id.* at 795.
[200] Alting, *supra* note 12, at 242.
[201] *Id.*

According to this doctrine, *qualified de facto Konzern* exists when a parent company exercises "a long standing and pervasive power of control" over the subsidiary[202]. In another words, the situation of *qualified de facto Konzern* exists when a parent company interferes with the subsidiary's affairs in "permanently" and in "an unrestricted manner"[203]. Similar to *factual Konzern*, in *qualified de facto Konzern* parent-subsidiary relationship are not based on the agreement but rather on the domination or control of one entity over another. However, compared to the *factual Konzern* where each detrimental interference should be proved, in *qualified de facto Konzern* the total domination of a parent company is presumed to be detrimental[204]. As a consequence a parent company can be held liable to subsidiary's creditors[205]. Thus, the degree of control of a parent entity over its subsidiary in *qualified de facto Konzern* is high.

As Reich-Graefe argues, the significance of the case law that created *qualified de facto Konzern* is that compared to *de facto Konzern* it follows improved approach[206]. As he points out, in *qualified de facto Konzern* the burden of proof is shifted from subsidiary to the parent company which has to prove that interference is not detrimental[207]. He also states that this concept "blended" liability regimes applicable with respect to *contractual Konzern and de facto Konzern* under AktG by providing that the existence of the group with extensive parent entity's control is sufficient for the liability of a parent entity[208].

Carsten Alting in his article[209] defines the scope of the concept of *qualified de facto Konzern*. Based on court decisions and views of commentators, he enumerates factors that help to determine the existence of qualified de facto group of companies[210]. One of the key factors is

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202 Reich-Graefe, *supra* note 150, at 796.
203 Alting, *supra* note 12, at 242.
204 *Id.*
205 Reich-Graefe, *supra* note 150, at 796.
206 *Id.*
207 *Id.*
208 *Id.* at 796-97.
209 *See* Alting, *supra* note 12.
210 See Alting, *supra* note 12, at 243-47

"material influence" that a parent entity exercises over the subsidiary[211]. Material influence is referred to "permanent influence" which is extensive and affects the dominated entity's assets, and when subsidiary turns merely into a "subdivision" of a parent company[212].

It is important to mention that case law with respect to qualified de facto groups was not static and has been changing over time[213]. As summarized by Sandra Miller, earlier cases applied more liberal approach by not requiring particular proof of abusive control by parent enterprise, however, later cases demonstrate that courts required control to be abusive, i.e. to be not in line with the subsidiary's interests[214].

Thus, imposition of liability under qualified de facto group was similar to enterprise liability theory discussed in previous chapter. Similar to enterprise liability principles, this concept suggested to consider not legal formalities but instead economic reality existing in a group when deciding whether to disregard the limited liability of a parent entity.

As stated by René Reich-Graefe, German courts abandoned this concept and came back to traditional entity principles[215]. When discussing the reasons why court decided to change the approach when dealing with the parent-subsidiary liability in *qualified de facto Konzern*, Reich-Graefe states that possible reason was that by formulating this concept, court went too far and created actually a rules, while traditionally in civil law countries, courts only deal with interpretation of the rules[216]. *Qualified de facto Konzern* concept created by analogy with provisions of AktG related to contractual corporate groups, was deemed to constitute creating

[211] *Id.* 243.
[212] *Id.* (citing *"Video"* Bundesgerichtshof [BGH] [Federal Court of Justice] Sept. 23, 1991, Neue Juristische Wochenschrift [NJW] 3142, 1991 (Ger.); *"Autokran"* Bundesgerichtshof [BGH] [Federal Court of Justice] Sept. 16, 1985, Neue Juristische Wochenschrift [NJW] 188, 1986 (Ger.); *"Gervais"* Bundesgerichtshof [BGH] [Federal Court of Justice] Feb. 5, 1979, Neue Juristische Wochenschrift [NJW] 231, 1980 (Ger.)).
[213] *See* Alting, *supra* note 12, at 244.
[214] Miller, *supra* note 48, at 106 (referring to *"Autokran"* Bundesgerichtshof [BGH] [Federal Court of Justice] Sept. 16, 1985, Neue Juristische Wochenschrift [NJW] 188, 1986 (Ger.); *"TBB"* Bundesgerichtshof [BGH] [Federal Court of Justice] Mar. 29, 1993, Neue Juristische Wochenschrift [NJW] 1200, 1993 (Ger.)).
[215] Reich-Graefe, *supra* note 150, at 802.
[216] *Id.*

new rules rather than judicial interpretation or judicial development of existing legal norms[217]. According to changed approach parent-subsidiary liability would arise in case when parent's interference "effectively destroys the continued, autonomous existence of the subsidiary ("*existenzvernichtender Eingriff")*[218]. It would involve instances when a subsidiary became either immediately insolvent or a subsidiary was caused to be in a situation of inevitable financial collapse[219].

Thus, application of liability regime of "intragroup liability concepts" to qualified de facto group is in the past[220].

2.6. Conclusion

German approach with respect to enterprise liability is quite different from the approach in the U.S. In Germany, regulation of corporate groups is quite elaborated and complex with the provisions providing for different types of groups and, hence, different types of parent-subsidiary liability regimes. Notable is the approach of contractual regulation of parent-subsidiary relationships and liability issues within contractual corporate group context. It brings certainly and predictability to parties and subject them to contractual obligations, violation of which entails both statutory and contractual liability. It is also very advantageous for the subsidiary's creditors that can rely on the parent entity's obligation to assume and compensate the subsidiary's losses and damages due to such agreement.

The provisions of AktG are not only limited to contractual corporate groups but they also apply with respect to factual corporate groups, where such elements as control and unified direction of management indicate the existence of a group. Although practically these rules might not be as

[217] *Id.* at 804.
[218] *Id.* at 800-801 (citing *"Bremer Vulkan II"* Bundesgerichtshof [BGH] [Federal Court of Justice] Feb. 25, 2002, Neue Juristische Wochenschrift [NJW] 22, 2002 (Ger.); *"KBV"* Bundesgerichtshof [BGH] [Federal Court of Justice] June 24, 2002, Neue Juristische Wochenschrift [NJW] 55, 2002 (Ger.)).
[219] Reich-Graefe, *supra* note 150, at 801-02.
[220] *Id.* at 806

efficient as those rules applicable in contractual group settings, nevertheless, they provide for some important protection of subsidiary, its shareholders and creditors as well.

Qualified de facto Konzern concept was developed as a response to groups of companies with high degree of domination of the parent company over the subsidiary, but which was not regulated by AktG. Courts elaborated rules that are based on the principles of enterprise liability theory. They focused on the economic reality that existed in the groups rather than considering mere legal formalities. It allowed "piercing the veil" of parent company's limited liability and imposition of liability on the parent enterprise because in reality a subsidiary was so dominated by it that there was no *de facto* separate corporate existence. Nevertheless, later this concept was abandoned and courts employed another approach. *Konzernrecht* with its comprehensive and elaborated rules can be an example for other countries in the area of regulation of corporate groups.

Chapter 3. "Enterprise liability" in Uzbekistan

3.1 Introduction to "enterprise liability" in Uzbekistan

The Civil Code of the Republic of Uzbekistan (hereinafter – "the Civil Code") sets the basic rules concerning types and forms of legal entities, their incorporation, operation and termination and contains other fundamental provisions[221]. Business entities can be in the form of economic partnerships and companies, production cooperatives, unitary enterprises and in any other form provided by legislation[222]. They vary depending on the liability of a legal entity and its owners, an entity's internal organization as well as organization of the property and capital. *Lex specialis* to the Civil Code are different Acts[223] which specialize on the regulation of the particular forms of legal entities. These Acts contain more elaborate and detailed provisions dealing with organization, operation, dissolution as well as managing, governing of each specific corporate form.

Limited liability and separate legal personality are important corporate law principles in Uzbekistan[224]. Similar to the U.S. and Germany, the main purpose of these principles are, on one hand, to encourage the investment in business and, on the other hand, to ensure that shareholders do not impose their personal obligations upon a legal entity and vice versa. The corporate law in Uzbekistan also provide for situations when the limited liability of shareholders can be disregarded. When this occur, law allows imposition of "subsidiary liability" or "joint and several liability" on a parent company for subsidiary's debts and obligations[225]. These concepts

[221] *See* GRAZHDANSKII KODEKS RESPUBLIKI UZBEKISTAN [GK R.UZB] [Civil Code of the Republic of Uzbekistan] (Uzb.).
[222] GK R.UZB art. 40 (Uzb.)
[223] *See e.g.* ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)], Sobranie Zakonodatel'stva Respubliki Uzbekistan [SZ R.Uzb.] [Collection of Legislation of the Republic of Uzbekistan], 2014, (Uzb.); ZAKON RESPUBLIKI UZBEKISTAN OB OBSHCHESTVAKH S OGRANICHENOI I DOPOLNITELNOI OTVETSTVENNOST'IU [Law of the Republic of Uzbekistan on Limited and Full liability Companies], Vedomosti Olii Majlisa Respubliki Uzbekistan [Ved. R.Uzb.] [Bulletin of Oliy Majlis of the Republic of Uzbekistan], 2002, (Uzb.).
[224] *See* GK R.UZB arts. 41, 48 (Uzb.).
[225] *See* GK R.UZB art. 329 (Uzb.) (provision on "subsidiary liability").

are different types of liability and they imply that a parent company becomes liable along with a subsidiary company[226].

This chapter analyzes the legal bases for parent-subsidiary relationship and the circumstances under which a parent company can be found liable for the obligations of its subsidiary under Uzbek law. The chapter starts with the discussion of the legal bases for establishing parent-subsidiary relationship. These bases provide for factual and contractual parent-subsidiary relationship and are important for further analysis of parent-subsidiary liability. The provision of the Civil Code explicitly regulating such legal bases is analyzed and each bases of such relationship is explained in this chapter. Inasmuch as "subsidiary liability" or "joint and several liability" are important for the analysis of "enterprise liability" in Uzbekistan and for the comparison with the previously discussed "enterprise liability" concepts in the U.S. and Germany, these types of liability are discussed separately. Three main provisions relevant to parent-subsidiary liability are important in this regard. They provide for imposition of "subsidiary liability" and "joint and several liability" on a parent company upon certain circumstances. These circumstances and the requirements envisaged in these provisions are analyzed and compared in this chapter. Throughout the chapter comparison with jurisdictions discussed in previous chapters is made.

3.2. Regulation of parent-subsidiary relationship

Unlike Germany, corporate law of Uzbekistan does not provide separate area of law regulating group of companies. Provisions on parent-subsidiary relationship and issues of liability in parent-subsidiary context are mainly contained in the Civil Code and the specific Acts[227].

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[226] CIVIL LAW VOLUME I (E. A. SUKHANOV ed., 2006), at 592-593 (unofficial translation).

[227] *See* GK R.UZB art. 67 (Uzb.) (it will be discussed later); ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)] art. 8 (Uzb.) (article stipulates that joint stock companies can have subsidiaries and expressly states that such subsidiaries can be in the form of limited liability company or joint stock company); ZAKON RESPUBLIKI UZBEKISTAN OB OBSHCHESTVAKH S OGRANICHENOI I DOPOLNITELNOI OTVETSTVENNOST'IU

In general, these provisions stipulate that both a parent company and a subsidiary company are separate legal entities[228]. However, due to certain legal and economic relations between these entities, they become distinct from other business entities. Similar to the U.S. and Germany, the main reason of distinguishing such relationships and subjecting them to the regulation, is the protection of interests of the subsidiary's shareholders and creditors as the subsidiary is deemed to be under the control of other business entity[229].

Among the provisions related to parent-subsidiary relationship, article 67 of the Civil Code can be considered as the main provision as it states the bases of establishing of such relationship. It also has wider scope of application compared to the specific Acts.

Pursuant to this provision, a parent entity can be in the form of *"economic partnership or company"* while a subsidiary entity can be in the form of *"economic company[230]"*. Hence, a parent company can be in the form of partnership, limited or full liability company, joint stock company, while a subsidiary company can be in the form of limited and full liability company and joint stock company.

Article 67 of the Civil Code states that a business entity can be considered as a subsidiary when a parent company can determine decisions that this entity adopts, and stipulates three bases when this may occur[231]. These bases are (1) predominant participation of a parent company in the subsidiary's authorized capital, (2) conclusion of an agreement between a parent company and a subsidiary company (3) other ways when the subsidiary's decisions can be determined by a

[Law of the Republic of Uzbekistan on Limited and Full liability Companies], art. 30 (Uzb.) (article envisages the authority of the general shareholders' meeting to adopt decision regarding the establishment of other legal entities); POLOZHENIE O KHOLDINGAKH POSTANOVLENIIA KABINETA MINISTROV RESPUBLIKI UZBEKISTAN [Regulation on Holding Companies of the Decree of the Cabinet of Ministers of the Republic of Uzbekistan], para. 3, sec. 1 (Uzb.) (this provision states that entities are considered to be subsidiaries when a holding company holds "controlling interest" in their capital).

[228] *See Id.*

[229] CIVIL LAW (A. P. SERGEEV AND YU. K. TOLSTOY eds., 2005), at 189 (unofficial translation).

[230] GK R.UZB art. 67 (Uzb.).

[231] *Id.*

parent company[232]. Since this provision does not specify the requirements with respect to each of these bases, following questions might arise: what constitute predominant participation in the subsidiary's capital, what type of an agreement can be regarded as prescribing right of a parent company to define decisions and what are those other ways by means of which a parent company can control a subsidiary.

Shareholding, explicit agreement, or any other indirect way of determining the decisions of other legal entity provided for in article 67 of the Civil Code suggest the presence of control as an important element when determining the existence of parent-subsidiary relationship.

Shareholding by a parent company in a subsidiary company's capital is one of the bases of parent-subsidiary relationship. It is important to note that not all shareholding leads to the creation of parent-subsidiary relationship. The term "predominant" implies holding of a significant amount of the subsidiary's shares so as to allow a parent company to exercise control over the subsidiary's decisions[233]. For example, a situation where a parent company holds the majority of voting shares that allows a parent company to determine the results of shareholders' meeting[234]. Predominant participation can refer not only to majority-shareholding but also to possession of a significant amount of shares compared to other shareholders[235].

An illustration of one of the possible interpretation of "predominant participation" can be made in light of *Holding Companies Regulation,* which stipulates that "controlling interest" of the holding company is any form of participation in the capital of other legal entity that secures the

[232] *Id.*
[233] COMMENTARY ON THE CIVIL CODE OF THE REPUBLIC OF UZBEKISTAN (H. R. RAHMANKULOV and SH. ASYANOV, eds., 2010), at 190-191 *(unofficial translation).*
[234] *Id.* at 191.
[235] *Id.* at 190-191.

right of adopting or rejecting of certain decisions[236]. This provision can be an example of what type of shareholding can lead to creation of parent-subsidiary relationship.

The discussion of the U.S. and Germany approaches in previous chapters showed that shareholding can be one of the factors establishing control of a parent company over its subsidiary in those jurisdictions. Article 67 of the Civil Code illustrates that under Uzbek law holding of other company's shares is also an indication of the existence of parent-subsidiary relationship.

Another basis for the parent-subsidiary relationship under article 67 of the Civil Code is the conclusion of an agreement between these entities. Article 67 does not clearly define the scope and content of such agreements[237]. As this agreement entitles a parent company to determine the subsidiary's decisions, such agreement probably includes the right of one party to make instructions and the obligation of the other party to heed to such instructions[238]. Absence of other requirements regarding the agreement can provide parties with a broad discretion to determine its content. However, it can also cause uncertainty as to what type of agreements can fall under this provision. In any case, these agreements have to be in accordance with laws and regulations.

This agreement can be compared to enterprise agreements in *contractual Konzern* provided for in German AktG, where the parties can directly regulate their "control-subjection" relationship by concluding a domination agreement or a profit-transfer agreement. Although article 67 of the Civil Code does not explicitly refer to such enterprise agreements, however, the agreement provided for in this provision can be a basis for similar contractual parent-subsidiary relationship.

[236] POLOZHENIE O KHOLDINGAKH POSTANOVLENIIA KABINETA MINISTROV RESPUBLIKI UZBEKISTAN [Regulation on Holding Companies of the Decree of the Cabinet of Ministers of the Republic of Uzbekistan], para. 2, sec.1 (Uzb.).
[237] RAHMANKULOV & ASYANOV, *supra* note 233, at 191.
[238] *Id.*

As to the third basis provided for in article 67 of the Civil Code, it can presumably refer to all other indirect ways by which one entity can control and influence the other[239]. For instance, it might be a situation when a parent company controls a subsidiary through participation in its authorized capital via several other subsidiaries that separately do not have significant shareholding in that entity[240]. In addition to this, it might be any *de facto* control that parent company exercises over the subsidiary. Such broad wording allows cases that do not fit into first two bases to fall under the scope of the provision. In this case a parent company exercising factual control will not be able to argue the absence of the shareholding or the agreement in order to object the existence of parent-subsidiary relationship.

Thus, similar to "veil piercing" concept in the U.S. and *de facto Konzern and qualified de facto Konzern* in Germany, control is a key element in establishing the existence of parent-subsidiary relationship under Uzbek law.

3.3. "Joint and several liability" and "subsidiary liability"

According to article 48 of the Civil Code legal entity shall be liable for its obligations with all its property[241]. Further it states that founder (member) of legal entity or owner of its property shall not be liable for the obligations of legal entity, and legal entity shall not be liable for the founder's (member's) or owner's obligations unless otherwise provided by this Code or legal entity's constituent documents[242].

This provision provides for a separation of liabilities of a legal entity and its owners[243]. It ensures that owners are not held liable for the obligations of the legal entity unless it is envisaged in the Civil Code or in the legal entity's constituent documents. Limited liability is not available for all corporate forms in Uzbekistan. Among corporate forms that provide limited liability to their

239 *Id.* at 192.
240 *Id.*
241 GK R.UZB art. 48 (Uzb.).
242 *Id.*
243 RAHMANKULOV & ASYANOV, *supra* note 233, at 128.

owners are “limited liability company” and “joint stock company”. According to article 62 of the Civil Code, members of limited liability company are not liable for the company’s obligations and bear the risk of loss relating to the company’s activities within the value of shares they contributed[244]. As stated in article 64 of the Civil Code shareholders of joint stock company are not liable for the company’s obligations and bear the risk of loss related to the company’s activity within the value of their stocks[245]. Thus, owners of entities in these corporate forms, bear the risk of loss only within the amount of their investment in the entity.

For the analysis of parent-subsidiary liability, it is important to mention such types of liability as “joint and several liability” and “subsidiary liability”. As a rule, these types of liability may arise either in cases prescribed by law or on the basis of an agreement[246]. “Joint and several liability” and “subsidiary liability” entitle a creditor to claim fulfillment of obligations not only from a debtor but also from a third legal entity which is considered to be a joint debtor or a subsidiary debtor[247]. These types of liability are aimed at ensuring the protection of creditors’ rights and serve as an additional guarantee of obtaining the fulfillment of obligations owed to them[248]. Although “joint and several liability” and “subsidiary liability” involve a third party who becomes liable along with a main debtor, they are distinct from each other. In “joint and several liability” both a main debtor and a joint debtor equally bear liability and a creditor can claim the fulfillment of an obligation either from the main debtor or from the joint debtor or from both of them[249]. On the other hand, in case of “subsidiary liability”, a subsidiary debtor bears additional liability, i.e. a creditor can make claim against a subsidiary debtor only if creditor’s claim against a main debtor was unsuccessful or inadequate[250].

[244] GK R.UZB art. 62 (Uzb.).
[245] *Id.* art. 64.
[246] RAHMANKULOV & ASYANOV, *supra* note 233, at 670; SUKHANOV, supra note 226, at 595-97.
[247] *See* GK R.UZB arts. 252, 329 (Uzb.).
[248] SUKHANOV, supra note 226, at 595-97.
[249] *See* GK R.UZB art. 252 (Uzb.).
[250] *See id.* art. 329.

These types of liability are particularly important when analyzing parent-subsidiary liability. The limited liability that a parent company may have due to its corporate form serves as a protection for a parent company from incurring liabilities of its subsidiary. “Subsidiary liability” and “joint and several liability”, as will be discussed further, can be triggered upon certain circumstances and can be viewed as an exception to the limited liability of a parent company.

3.4. Regulation of parent-subsidiary liability

Liability of a parent company for the subsidiary’s debts and obligations depends on the parent company’s corporate form. If a parent company is in the form of “limited liability company” or “joint stock company”, it has limited liability and, therefore, the obligations of its subsidiary should not be imposed upon it[251]. However, under some circumstances limited liability of a parent company can be disregarded and it can be found liable for the debts and obligations of its subsidiary. In this case, law provides for “subsidiary liability” or “joint and several liability” of a parent company.

Three provisions relevant to the issue of the parent-subsidiary liability are important in this regard. These provisions lay down circumstances under which such disregard of the limited liability might occur and stipulate what liability should follow in those cases.

Article 48 of the Civil Code regulating the liability of legal entities, states that owners are not liable for the legal entity’s obligations, however, it allows exceptions to this rule when it is stipulated in the Civil Code or envisaged in the entity’s constituent documents[252]. It further provides for one of such exceptions[253]. In light of all the requirements that this provision impose, the scope of application of this exception can be considered as quite narrow.

[251] *See id.* arts. 62, 64.
[252] *Id.* art. 48.
[253] RAHMANKULOV & ASYANOV, *supra* note 233, at 128.

This provision can be applicable only in case of insolvency of the legal entity due to wrongful acts of an owner or a member of the entity who has a right to give binding instructions to the entity and such right is envisaged in the constituent documents of the entity[254]. This provision requires causal link between the insolvency and the wrongful act[255]. In addition to this, there has to be an intention to cause harm to the entity, *viz.* the owner used the right to give binding instructions in order for the legal entity to act while being aware that as result the entity would be insolvent[256]. Thus, if all these factors are present and if the entity's assets are insufficient, "subsidiary liability" can be imposed on the owner or member of the entity[257].

Although this provision is not specifically related to the parent-subsidiary context, however, it can also be applicable with respect to corporate shareholders[258].

Provision that specifically addresses the issues of liability in the parent-subsidiary context is article 67 of the Civil Code. It is applicable in case of subsidiary's insolvency[259]. The imposition of "subsidiary liability" on a parent company for the subsidiary's debts in such case is possible if the insolvency was caused by parent company's fault[260]. The rule contained in this article, similar to "veil piecing" concept in the U.S. and provisions of *Konzernrecht* in Germany, is used in order not to allow a parent company to treat and use its subsidiary as a means to avoid liability and to be liable in the presence of fault.

Compared to article 48, article 67 does not require the presence of prior knowledge that causing the subsidiary to act would result in its insolvency.

The insolvency of a subsidiary is very extreme situation. If a parent company utilizes its right to control a subsidiary in an improper manner, by imposing such liability on a parent company the

[254] GK R.UZB art. 48 (Uzb.).
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] RAHMANKULOV & ASYANOV, *supra* note 233, at 129.
[259] GK R.UZB art. 67 (Uzb.).
[260] *Id.*

law ensures that creditors and subsidiary's shareholders have opportunity to receive the fulfillment of their claims.

From the creditor's perspective, these provisions are deemed to be very limited in scope as they allow for the liability to be imposed on a parent company only in very specific situations. However, from the parent company's perspective, it can be viewed as ensuring its limited liability towards the subsidiary's obligations.

Another provision important for the analysis of parent-subsidiary liability is article 8 of Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights[261] (hereinafter – "Joint Stock Company Act"). In comparison with the provisions discussed above, article 8 of Joint Stock Company Act provides for other situation when a parent company can be held liable for its subsidiary's debts and obligations[262]. It provides for imposition of "joint and several liability" on a parent company, that has a right to give binding instructions to the subsidiary, for the transactions which have been concluded by the subsidiary in order to fulfill such instructions[263]. It further states that the right to give binding instructions should be envisaged in an agreement with a subsidiary or in a subsidiary company's charter[264]. This provision requires a link between the parent company's binding instructions and a transaction that has been concluded by the subsidiary. The requirements of this provision are also very specific and can be compared to the requirements applicable in case of *de facto Konzern* under German AktG. Similarly, it might be difficult to single out the instruction and the transaction that has been conducted by a subsidiary especially if business relationships of two entities are extensive.

[261] *See supra* note 227.
[262] ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)], art. 8 (Uzb.).
[263] *Id.*
[264] *Id.*

Article 8 of Joint Stock Company Act also envisages the situation of imposition of liability in cases of a subsidiary's insolvency. This article follows similar pattern of article 48 and article 67 of the Civil Code with respect to regulation of such cases. It also requires a causal link between the insolvency of a subsidiary and the fault of a parent company[265]. Further, it states that insolvency is considered to be caused due to a parent company's fault when a parent company has given to a subsidiary company binding instruction for a subsidiary to act, while being aware that it would result in the subsidiary's insolvency[266].

Although article 8 of Joint Stock Company Act can only be applicable to joint stock companies, however, it can be considered broader compared to other provisions discussed above as the liability of a parent company is not only limited to the cases of the subsidiary's insolvency.

As it concerns the claim against a parent company in case of imposition of subsidiary liability in situation of insolvency, article 128 of the Law of the Republic of Uzbekistan on Bankruptcy[267] states that bankruptcy trustee has a right to make claims against third parties who according to law bears subsidiary liability for monetary obligations due to causing insolvency of a debtor[268]. Recovered amount shall be included to the bankruptcy estate and can be distributed only according to the order of priority of claims (classes of creditors in bankruptcy proceedings) prescribed by the Statute[269]. In cases of liability of a parent company when it caused insolvency of its subsidiary company, a subsidiary company's creditor can recover debts through the bankruptcy proceedings.

3.5. Conclusion

[265] *Id.*
[266] *Id.*
[267] ZAKON RESPUBLIKI UZBEKISTAN O BANKROTSTVE (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Bankruptcy (amended version)], Vedomosti Olii Majlisa Respubliki Uzbekistan [Ved. R.Uzb.] [Bulletin of Oliy Majlis of the Republic of Uzbekistan], 2003, (Uzb.).
[268] ZAKON RESPUBLIKI UZBEKISTAN O BANKROTSTVE (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Bankruptcy (amended version)], art. 128 (Uzb.).
[269] *See id.* arts. 128, 133, 134.

Similar to Germany, under corporate law of Uzbekistan parent-subsidiary relationship can be established based on factual and contractual grounds. A parent company can exercise control over a subsidiary by virtue of holding significant amount of its shares or based on the agreement concluded with the subsidiary. Additionally any other way of exercising control can also be covered by the provision regarding parent-subsidiary relationship.

Similar to Germany and the U.S., in Uzbekistan principles of separate legal personality and limited liability protect a parent company from incurring debts of a subsidiary company. Exceptions to the parent's limited liability are also provided for under Uzbek corporate law. These provisions allow imposition of "subsidiary liability" and "joint and several liability", which are different types of liability. However, the scope of application of these provisions is not broad and mainly relate to situations when insolvency is caused by a parent entity's fault. As to the "joint and several liability" of a parent entity, it can be imposed on a parent entity for the transactions entered into by the subsidiary based on the parent company's instructions.

Chapter 4. Comparison of the "enterprise liability" doctrine in three jurisdictions and proposals for Uzbekistan

4.1. Introduction

All three jurisdictions discussed in previous chapters have developed their own approaches on the issue of parent company's liability for its subsidiary obligations. Each of these approaches has advantages as well as disadvantages and certainly a room for further development.

Along with the comparative points that have already been made in previous chapters, it is important to compare the approaches in the U.S., Germany and Uzbekistan regarding the issue of parent-subsidiary liability with the focus on the following aspects: the source of the "enterprise liability" rules, the rationale behind these rules and the scope of their application.

This chapter provides comparison of "enterprise liability" rules in these jurisdictions with the focus on abovementioned aspects. The purpose of such comparison is to see similarities and differences of the approaches and to identify their advantages and drawbacks. The comparative analysis can also help to see how the rules regulating parent-subsidiary liability under Uzbek law can be improved. The chapter discusses the proposals for further improvement of "enterprise liability" rules in Uzbekistan.

4.2. Comparison of the "enterprise liability" doctrine in three jurisdictions

The U.S. "veil piercing" equitable concept is a creation of case law[270]. Due to its different application by courts in different states, there appeared several "variations" of the "veil piercing" concept[271]. The requirements of "veil piercing" test are not clearly defined, and, therefore, the question whether a particular situation can reach a necessary threshold depends upon the court's interpretation and application of the concept and the circumstances of the case[272]. In contrast, "enterprise liability" rules that have statutory nature can cause different type of problem. Rules

[270] Alting, *supra* note 12, at 192-93.
[271] *Id.* at 193.
[272] *See* Strasser, *supra* note 9, at 641-42.

related to "subsidiary liability" in Uzbekistan and *de facto Konzern* in Germany contain very specific requirements to be present in order to invoke these rules. Therefore, imposition of liability on a parent entity for the subsidiary's obligations based on these rules might be difficult.

Comparison of case-law created rules and statutory rules with respect to this issue helps to see that both approaches require balance. Therefore, in order to provide subsidiary's shareholders and creditors with adequate protection but at the same time not to diminish the principle of limited liability, rules related to parent-subsidiary liability should, on one hand, clearly stipulate their scope of application and the requirements that should be met, but also leave some discretion to courts to decide based on the particular circumstances of the case.

Another important aspect to compare among these approaches is the rationale behind the rules. It will help to understand how these rules work and what can be done to improve them.

Courts applying "piercing corporate veil" concept in the U.S. mainly look at two key elements that allow limited liability of a parent company to be disregarded. They are the absence of separate corporate existence of a subsidiary and a parent company's wrongful conduct or fraud[273]. The presence of these elements indicates that a parent entity treated the subsidiary not as distinct corporate entity but as a department or division of the enterprise[274]. Since a parent entity conducted a wrongful act and disregarded the separate corporate existence of a subsidiary, it should not be entitled to rely on limited liability protection with respect to such acts.

Under Uzbek law imposition of a "subsidiary liability" on a parent entity for the obligation of its subsidiary is mainly focused on the presence of parent entity's fault in causing the insolvency of the subsidiary[275]. Exercising control over a subsidiary in a way that leads to its insolvency makes a parent company liable for the debts and obligations of a subsidiary which it incurred due to

[273] *See id.* at 640; Dearborn, *supra* note 33, at 203-204; Miller, *supra* note 48, at 88.
[274] Alting, *supra* note 12, at 228.
[275] *See* GK R.UZB art. 48, 67 (Uzb.); ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)], art. 8 (Uzb.).

such control. As it concerns liability of a parent company for the transactions concluded by its subsidiary under the parent company's instruction, attribution of liability to the parent company in such case is similar to the idea of "agency relationship".

Under German law, in *contractual Konzern* as a parent entity becomes entitled to control the subsidiary under enterprise agreement, it has to ensure assumption of all its losses[276]. On the contrary, in *de facto Konzern,* imposition of liability on a parent entity is possible only in case the particular interference is detrimental[277]. As to *qualified de facto Konzern*, the rationale behind these rules are similar to contractual Konzern, where a subsidiary is part of a single enterprise and all the losses should be attributed to parent company[278].

Analysis of the rules from this perspective helps to see that they are all based on the similar idea. As losses or damages have been caused by a parent entity that acted in an improper way, it should be liable for such losses and cannot rely on the principles of separate corporate existence and limited liability in such situations.

In light of the discussion in previous chapters, the approaches of all three jurisdictions can be considered as "limited liability principle" protective. It is quite reasonable because limited liability is the rule and imposition of liability upon a parent entity for its subsidiary's obligations is the exception to this rule.

It is not easy to pierce the corporate veil and hold a parent company liable in the U.S., unless there are certain grounds to do so[279]. Compared to the U.S. and Germany, the rules under Uzbek law are very specific as to the situations and circumstances when they can be invoked. As to the rules under German law, in *contractual Konzern* a parent entity is viewed as waiving its limited liability with respect to the parent-subsidiary relationship based on the agreement with the

[276] *See* AktG § 302, *translated in* supra 136; *See also* Alting, *supra* note 12, at 236.
[277] Reich-Graefe, *supra* note 150, at 790-91.
[278] *Id.* at 797.
[279] *See* Miller, *supra* note 48, at 79.

subsidiary[280]. However, in case of *factual Konzern* the limited liability of a parent company is more protected as the requirements on imposition of liability are very specific[281].

4.3. Proposals for further improvement of the "enterprise liability" rules in Uzbekistan

In light of the discussion provided in previous chapters, analysis and comparison of "enterprise liability" rules in the U.S., Germany and Uzbekistan allow following proposals to be made for further improvement of the provisions of Uzbek law related to regulation of parent-subsidiary relationship and liability of a parent entity for the obligation of its subsidiary.

Article 67 of the Civil Code is a provision that provides for legal bases of establishing parent-subsidiary relationship[282]. This provision is also crucial for the analysis of the issue of parent-subsidiary liability. As discussed in Chapter 3, according to this provision parent-subsidiary relationship can be established either on the basis of "substantive" shareholding, agreement or in other ways[283]. Even though this provision encompasses various bases for establishing of parent-subsidiary relationship among legal entities, nevertheless, it does not specify the requirements with respect to each of these bases[284]. There is no indication as to the amount of shareholding which is sufficient to create parent-subsidiary relationship or the requirements to the agreement and its content. This might cause some practical problems in case of application or interpretation of this provision.

Therefore, this provision should contain certain guidelines on how to determine each of those bases. For example, this provision should specify what constitutes "predominant amount of shares" either by stating the amount or proportion of shares or specifying what rights such shareholding should entail. The content of the agreement establishing parent-subsidiary relationship is also important to specify in order to exclude the disputes whether a particular

[280] Reich-Graefe, *supra* note 150, at 789.
[281] *Id*, at 791.
[282] *See* GK R.UZB art. 67 (Uzb.).
[283] *See id.*
[284] *See id.*

agreement can fall under the scope of the provision. In this regard, providing requirements as to the subject-matter of the agreement, parties' rights and liabilities, protection of creditors can help to bring clarity to the rule. In addition to this, provisions similar to rules applicable to *contractual Konzern* in Germany that protect the interests of shareholders and creditors when such agreement is concluded can be also introduced[285]. It can ensure that even if such agreement is concluded, the rights and interests of minority shareholders and creditors will not be affected.

Other proposals that can be introduced relate to provisions regulating parent-subsidiary liability discussed in Chapter 3.

These provisions[286] are very crucial for the protection of the interests of a subsidiary and its creditors as they provide for imposition of liability upon a parent entity for the obligations of the subsidiary. These rules ensure that a parent company does not use its ability to control the subsidiary in an improper manner. However, as it has been discussed earlier, since these provisions impose very specific requirements to be present in order to invoke them, therefore, they might have limited scope of application.

Articles 48 and 67 of the Civil Code are applicable in cases of subsidiary's insolvency when it was caused due to a parent company's fault[287]. Thus, cases other than insolvency of the subsidiary might be left outside their scope. In addition to this, the requirements regarding presence of fault and awareness of a parent entity that such instruction might lead to the subsidiary's insolvency can also limit the scope of their application. Therefore, these provisions should be extended to all situations when a parent entity's interference caused losses or damages to a subsidiary. It would ensure better protection of the subsidiary's creditors and shareholders.

[285] *See* AktG §§ 300, 302, 303, *translated in* supra 136.
[286] *See* GK R.UZB art. 48, 67 (Uzb.); ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)], art. 8 (Uzb.).
[287] *See id.*

As to the liability of a parent entity for the transactions and agreements concluded by a subsidiary based on the parent entity's instructions provided for in article 8 of Joint Stock Act, by stipulating that the right to give binding instructions has to be envisaged either in the agreement or in subsidiary's charter leave situations of factual control outside of the scope of this provision[288]. Therefore, it would be more practical to allow the situations of factual control also to be included in its scope.

[288] ZAKON RESPUBLIKI UZBEKISTAN OB AKTSIONERNIKH OBSHCHESTVAKH I ZASHCHITE PRAV AKTSIONEROV (NOVAYA REDAKTSIIA) [Law of the Republic of Uzbekistan on Joint Stock Companies and the Protection of Shareholder's Rights (amended version)], art. 8 (Uzb.).

Conclusion

The analysis and comparison of the “enterprise liability” concepts in the U.S., Germany and Uzbekistan showed that each of these jurisdictions has its own approach with respect to regulation of the issues of parent-subsidiary liability. In the U.S. parent-subsidiary liability is covered by the “piercing the corporate veil” concept, which is an equitable doctrine developed by case law. Under this concept different variations of veil piercing concept have been created, however, they are considered to be imposing the same requirements and are used interchangeably. In Germany and Uzbekistan rules on parent-subsidiary liability are regulated mainly by law. In Germany, regulation of liability of a parent entity is closely related to the notion of corporate groups. Depending on the type of a corporate group, different rules on liability apply and therefore the scope of liability of a parent entity also varies. In Uzbekistan, rules regulating parent-subsidiary liability allows imposition of “subsidiary liability” or “joint and stock liability” on a parent entity. These types of liability allow creditors to make claim not only from a subsidiary but also from a parent entity.

Analysis of the rules regulating parent-subsidiary liability in these jurisdictions, helped to reveal their similarities, differences as well as their advantages and drawbacks. Based on this analysis and comparison certain improvement of these rules can be introduced in Uzbekistan. The existing rules regulating parent-subsidiary liability have important place in the legal system. They provide protection of creditors’ and shareholders’ interests and introduction of such improvements will contribute to this aim.

In light of the analysis of the rules regulating parent-subsidiary relationship and liability issues in Uzbekistan provided in this thesis, future research in such areas as regulation of corporate groups and types of liabilities applicable in case of parent-subsidiary liability is important. As the discussion in this thesis showed the issue of parent entity’s liability for the obligations of its subsidiary is closely connected with the concept of parent-subsidiary relationship or corporate groups. Therefore, research in the area of corporate groups with the example of German *Konzernrecht* can provide better view on the improving provisions regulating parent-subsidiary liability. Moreover, further research can be conducted to analyze particular ways of broadening the scope of the provisions regulating imposition of “subsidiary liability” and “joint and several liability” on a parent entity for its subsidiary’s obligations.

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