PIERCING THE CORPORATE VEIL:

AUSTRALIA AND CHINA

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This thesis is presented for the Honours degree of Bachelor of Laws of

Murdoch University

December 2014

(19, 675 words excluding footnotes and bibliography)
DECLARATION OF ORIGINALITY

I, Szu-Shen Tham, declare that this thesis is the result of my own work and effort and it has not been submitted anywhere else. Where other sources have been used, they have been referenced accordingly.

Dated: 1st December 2014
ACKNOWLEDGMENTS

I would like to thank my supervisor, Haydn Rigby at the School of Law, Murdoch University, for his great advise and expertise in the writing of this thesis. Without his input, this thesis would not have been possible.

I would also like to thank my family for their love, and encouragement throughout this journey. It is invaluable to know that all of you were encouraging me to the end of this journey. Thanks.

Special thanks to Bernie Gan for his unconditional love and support. Thanks for being there for me when I am at the verge of breaking down and thanks for always making me laugh.

Finally, thanks to Mabel, Nathalie, Shuh Min and my other friends for their company and constantly making sure that I stay sane during this thesis.
Abstract

While Australia has long adopted the corporate veil piercing doctrine from the UK model, China has only recently enacted veil piercing provisions in 2006. This thesis compares Australia’s long standing veil piercing doctrine and China’s recent veil piercing enactment to determine which jurisdiction provides better veil piercing laws in protecting creditors’ interests. The findings of this thesis are significant for creditors such as foreign lenders or business partners who wish to choose a well-protected and safe market in which to invest.

This thesis will provide a discussion and comparison on Australia’s and China’s directors’ duties to prevent insolvent trading and instances in which veil piercing can occur. There will be an addition of another jurisdiction, United States in lieu of China, because China’s insolvent trading laws are based on US laws and there is a dearth of academic literature in the area of insolvent trading laws in China.

This thesis will argue that Australia has better veil piercing laws to protect creditors’ interests compared to China due to the very limited scope of China’s veil piercing laws, which are drafted in vague terms and the Chinese civil legal system (in which the doctrine of precedent is absent). In addition, the author suggests that this is due to the fact that many companies are still State Owned Enterprises in China, subject to strong political influence and therefore protective of state shareholders.
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INTRODUCTION

In 2014, about ten thousand companies in Australia went into external administration.\(^1\) This presents a complication for creditors attempting to recover their debts from these insolvent companies, as they will either fail to recover their debts or will only able to recover a portion of them.\(^2\) This is because these companies may not have enough assets to repay their creditors and in some circumstances, the controllers of these companies may have directly or indirectly caused this.

However, the principle of ‘piercing the corporate-veil’ provides some assurance to these creditors in certain circumstances where it can be invoked. For example, creditors may have legal recourse against directors personally, if they breach their fiduciary obligations.\(^3\)

This thesis focuses on a comparison between two jurisdictions, Australia’s and People’s Republic of China (‘China’) veil piercing laws. The objective of this comparison is to determine which jurisdiction provides better veil piercing laws to protect creditors’ interests. The discussion and analysis are in the subsequent chapters of this thesis, Chapter II – Directors’ Duties (Insolvent Trading) and Chapter III – Piercing the Corporate Veil. This thesis will only discuss the veil-piercing laws in relation to contract creditors.

\(^3\) Philip Lipton, Abe Herzberg and Michelle Welsh, Understanding Company Law (Thomson Reuters, 17th ed, 2014) 41.
because contract creditors are more common in a company’s everyday transactions compared to creditors who may have action against the company in tort.

This thesis will be divided into four chapters. Chapter I – Introduction, will deliver an overarching description of limited liability and separate legal entity principles, explaining the ‘veil-piercing’ doctrines developed from these principles.

Chapter II - Directors’ Duties (Insolvent Trading), will discuss a director’s duties in Australia and China in relation to insolvent trading. There will be an in-depth analysis of directors’ duties in relation to insolvent trading. There will also be a comparison between Australia and the United States (‘US’) in lieu of China because China’s insolvent trading laws are modelled on US’s because there is a dearth of academic literature in China on this area of law. This Chapter will compare directors’ duties across both jurisdictions with particular focus on breaches of these duties, which trigger ‘veil-piercing’ action.

Chapter III- Piercing the Corporate Veil compares and evaluates laws on the ‘veil-piercing’ doctrine in both jurisdictions. It discusses the disparity between ‘veil-piercing’ laws.

Chapter IV- Conclusion, summarises each chapter succinctly and forms this thesis’ conclusion that Australia arguably accords better protection for creditors.
‘Piercing the corporate veil’ describes the court’s action to hold shareholders and directors personally liable for the company’s debt.³ Australia’s veil-piercing doctrine is modelled on the United Kingdom’s (‘UK’) veil-piercing doctrine and its history can be traced back to the early 1910s in UK.⁴ Thus, Australia’s veil-piercing doctrine has been developing over a century through cases and legislation.⁵ This development has provided an opportunity for many academics to discuss and analyse the doctrine.⁶ This thesis will add novelty to this ongoing discussion of the doctrine by comparing it with another jurisdiction, China, because of its recent addition of veil-piercing doctrine to its Company Law.

China has recently reformed its company law, Chinese Company Law 2006 (‘CCL’) by including the ‘veil piercing’ doctrine.⁷ China is a rapidly

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³ Ibid.
⁵ Electric Light and Power Supply Corporation Ltd v Cornack (1911) 11 SR (NSW) 350.
advancing economy and with the recent reform of the CCL, the question is whether its laws have evolved fast enough to address industrial loopholes or forge an investor-safe environment.

This thesis will attempt to analyse the ways in which ‘veil piercing’ doctrine protects creditors’ interests in Australia and China.

A Corporation and Types of Companies

Before this thesis explains the concepts of limited liability and separate legal entity status, it is imperative to first define company related terms and the different types of company so readers may accurately understand terms used in this thesis. It is also important to note that the types of company differ in Australia and China and that certain terms such as 'corporation’ are also defined differently in both jurisdictions. Thus, the definitions of each type of company will be segmented by jurisdiction and this thesis will first discuss the definition and types of company in Australia before discussing China.

1 Australia

Under this segment, the definition of the term ‘corporation’ will be discussed followed by an explanation of each type of company under the Corporations Act 2001 (Cth) (‘the Act’).
(a) Definition of Corporation

A ‘corporation’ is often confused with a ‘company’. A corporation is a business entity acknowledged by law as a legal person with its own rights and liabilities.\textsuperscript{9} According to section 57A of the Act, a company registered under the Act is a type of corporation, thus the definition of the respective terms differ.\textsuperscript{10} A company is a corporation but a corporation is not always a company because a company falls within the ambit of a corporation, which also includes any incorporated and unincorporated bodies that may sue or be sued or hold property in the name of an office holder appointed for that purpose.\textsuperscript{11}

(b) Types of Companies

There are two main types of companies which can be registered in Australia: proprietary companies and public companies.\textsuperscript{12} These two types of companies are further categorised into four ‘categories’: limited by shares, limited by guarantee, unlimited with share capital and no liability. Table A illustrates this concept

\textsuperscript{9} Corporations Act 2001 (Cth) ss 9 and 57A.
\textsuperscript{10} Ibid s 57A.
\textsuperscript{11} Ibid s 57A.
\textsuperscript{12} Ibid s 112.
(i) Proprietary Companies

Proprietary companies are often small or subsidiary companies and are generally referred to as ‘private’ companies and are sometimes used as shelf companies. The definition of proprietary companies is given under section 45A of the Act; a proprietary company must either be limited by shares or be an unlimited company with share capital, it must have no more than 50 non-employee shareholders, and must not do anything that would require disclosure to investors under Chapter 6D.

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13 Small proprietary company is one that, for a financial year, satisfies two or more of the following criteria: consolidated gross operating revenue for the company and entities it controls is less than $25 million, value of consolidated gross assets at the end of the financial year of the company and entities it controls is less than $12.5 million, the company and entities it controls has fewer than 50 employees at the end of the financial year, Corporations Act 2001 (Cth) ss 9 and 45A(2).

14 Corporations Act 2001 (Cth) s 45A; see also Corporations Act 2001 (Cth) ss 113(1) and 112(1); Corporations Act 2001 (Cth) Chapter 6D deals with fundraising (offering of shares to public).
(ii) Public Companies

There is no express definition of ‘public company’ in the Act. The Act merely states that ‘a public company is a company other than proprietary company’ and that it is listed on a prescribed financial market such as the Australia Securities Exchange Ltd (ASX) or the New York Stock Exchange (NYSE)\textsuperscript{15}.

The thesis will only focus on companies limited by shares because these have both limited liability and separate legal entity status\textsuperscript{16}. This thesis will not analyse companies limited by guarantee because these companies are usually non-profit\textsuperscript{17}. This is in contrast to companies limited by shares, which are profit-driven and require directors and shareholders to routinely assess and take investment risks\textsuperscript{18}. These risks, whether taken in good or bad faith, may lead to the piercing of the corporate veil, providing ample material for discussion on the section in this thesis dealing with breaches of directors’ duties.

\textsuperscript{15} Corporations Act 2001 (Cth) ss 9 and 195 (a)(ii).
\textsuperscript{16} Ibid s 57A.
\textsuperscript{17} Lipton, above n 3, 82.
\textsuperscript{18} Ibid 81.
Companies limited by shares can be public or proprietary companies.\textsuperscript{19} Section 9 of the Act defines a company limited by shares as ‘a company formed on the principle of having its members liability limited to the amount, if any, unpaid on the shares respectively held by them’.\textsuperscript{20} In other words, shareholders’ liabilities are only limited to the nominal value (value of shares at the time they are issued to shareholders) of their unpaid shares.\textsuperscript{21}

Since shareholders of a company limited by shares have limited liability, the company’s creditors do not have access to the shareholders’ personal wealth when recovering their debts in the event of insolvency since shareholders of a company limited by shares have limited liability.\textsuperscript{22} Therefore, such a company is required to include the word ‘limited’ or the word ‘Ltd’ at the end of the company’s name.\textsuperscript{23} The reason for this is to caution prospective creditors that they are only allowed to access to the company’s assets to satisfy their debts.\textsuperscript{24}

This thesis will now shift its focus to China and discuss the term ‘corporation’ under CCL and the types of companies that can be registered under this Act.

\textsuperscript{19} Corporations Act 2001 (Cth) s 112.
\textsuperscript{20} Unpaid shares are share allotments that have not been paid, Kym Anderson, Australia’s Economy in Its International Context (University of Adelaide Press, 2009) 100; Corporations Act 2001 (Cth) s 9.
\textsuperscript{21} Kym Anderson, Australia’s Economy in Its International Context (University of Adelaide Press, 2009) 100.
\textsuperscript{22} Lipton, above n 3, 81.
\textsuperscript{23} Corporations Act 2001 (Cth) s 148(2).
\textsuperscript{24} Ibid.
2 China

(a) Definition of Company

In CCL, there is no reference to the term ‘corporation’. The revised statute, CCL, only refers to the term ‘company’.\(^{25}\) According to Article 2 of the CCL, ‘company’ is referred to a limited liability company or joint stock company (public limited company).\(^{26}\) Similar to Australia, a company in China is recognised by law as a legal person, owns its own property and has the rights to enjoy its own property as a legal person and be liable for debts.\(^ {27}\) In addition, shareholders have the privilege of the limited liability principle once they contribute their subscribe capital into the company.\(^ {28}\) This means that the separate legal entity status and limited liability principle exist upon incorporation of the company under the CCL.\(^ {29}\)

(b) Types of Companies

There are three types of companies that can be registered under the CCL. The author will describe each type of company, which are limited liability company, joint-stock company and state-owned enterprise.

\(^{26}\) Ibid.
\(^{27}\) Ibid art 3.
\(^{28}\) Ibid.
\(^{29}\) Ibid.
(i) Limited Liability Company

There is no express definition of a limited liability company (‘LLC’) in China. The CCL only provides that LLC has the characteristics of limited liability and separate legal entity status principles. 30

LLC in China are usually middle or small sized enterprises and include single shareholder LLCs. 31 The primary difference between a normal LLC (a two or more shareholders LLC) and a sole shareholder LLC is the minimum capital contribution. 32 For a two or more shareholders LLC, the minimum capital contribution is RMB 30,000, whereas the minimum capital contribution of a sole LLC shareholder is RMB 100,000. 33 There is a higher minimum capital level imposed on sole shareholder LLC to prevent any abuse of corporate structure in a sole shareholder LLC. 34 This restriction is an attempt to balance the benefits of the limited liability principle to potential investors while still protecting creditors. 35

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31 Ibid.
33 Ibid.
35 Yun, above n 30.
(ii) Joint Stock Company

A Joint Stock Company (‘JSC’) is also known as a company limited by shares. The company’s total capital is divided into equal shares and shareholders take the shares issued to them and are only be liable to the extent of shares subscribed respectively by them. Where a JSC in Australia can be a public or private company, a JSC can only be a public company in China. It is established primarily in order to be listed on Chinese or foreign stock markets. In order to be registered as a JSC in China, a minimum of 20% of the capital to be invested by shareholders or a minimum of 25% from foreign investors and a minimum capital requirement of RMB 5 million is required for investment. A large number of these companies are set up to attract foreign investment.

Although JSC and LLC seem to be similar, there are a number of differences between them. The difference between JSC and LLC is the restriction on the amount of shareholders. LLC’s shareholders are limited to 50, whereas JSC

38 Ibid art 86.
39 Ibid art 78.
does not have any limit on the number of shareholders in their company.\(^{42}\) In addition, laws are more stringent on JSC as compared to LLC. For example, the minimum registered capital of an LLC is RMB 30,000, while a JSC’s minimum registered capital is RMB 5 million.\(^{43}\) Thirdly, as mentioned above, JSC’s total capital is divided equally to be issued whereas LLC does not divide them and issue them. Instead, LLC’s shareholders agree on the equity in percentage holding.\(^{44}\) Lastly, a JSC can list their shares on the securities exchange market whereas for a LLC to do so, they require approval from shareholders.\(^{45}\)

(iii) Wholly State-Owned Limited Liability Enterprises as Companies (State-Owned Enterprises)

A state-owned enterprise (SOE) is wholly or mainly owned by central, provincial or city governments. SOEs used to be the backbone of China’s economy, exporting 90% of its output and employing the majority of its workforce in 1980s.\(^{46}\) Since reforms in 1980s, the private sector has overtaken the importance of SOEs. In 2003, SOEs contributed less than a third of the total economic output.\(^{47}\)

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\(^{43}\) Ibid arts 26, 81.
\(^{44}\) Wang, above n 41, 25.
\(^{45}\) Wang, above n 41, 56.
\(^{47}\) Ibid.
Before the 1980s reforms, the Chinese government directly controlled SOEs. They decided on the materials used, amount of output and labour force. Managers and supervisors of SOEs do not have control over the governance of the company. The reforms introduced the concept of separate legal entity status and legal person status to SOEs, which were then allowed to exercise their functions and powers in accordance with CCL. SOEs’ boards of directors are allowed to exercise their functions and powers in accordance with CCL.

CCL defines SOE as ‘a limited liability company wholly funded by State’ in which the central or local authority in charge of the administration of state assets is authorised to serve as the investor/shareholder. The State is the only shareholder of its company and is represented by the central State-owned Assets Supervision and Administration Commission (SASAC) and provincial SASACs. The CCL recognises that the State does not have to bear unlimited liability unless its directors or managers abuse the management of the company.

This thesis will analyse LLC, JSC and SOE when discussing China’s laws on director duties and ‘veil-piercing’ doctrines.

48 Wang, above n 46, 2.
51 Wang, above n 41, 56.
52 Ibid 55.
This Chapter will now analyse the principle of limited liability, followed by the principle of ‘separate legal entity’ status. The CCL is modelled on the common law doctrine of limited liability and separate legal entity status.\(^{54}\) Thus, the author will provide the history and definition of limited liability and separate legal entity status following the UK and Australian experience.

**B Limited Liability**

This segment will first explain the definition of ‘limited liability’ and will provide a brief history of how this principle became to play a principal role in setting up a company. It will also discuss the benefits of limited liability as a principal characteristic of a company. This segment is important as it accentuates the importance of limited liability acting as a shield for directors and shareholders.

1 *Definition*

The principle of limited liability means that the shareholders are not personally liable for the company’s debts and are only limited to the amount of capital they invested.\(^{55}\)

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54 Wen above n 34, 321.
2 Brief History

The adoption of the concept of limited liability in Australia can be traced back to the UK. Limited liability was first introduced by the *Limited Liability Act 1855* (UK). That Act provided that the liability of shareholders would not be beyond the amount invested. For example, if the shareholder bought $200 worth of shares, the maximum amount risked was $200.

Before the introduction of limited liability, the Act, *United Kingdom Joint Stock Companies Act 1844* (UK) only allowed company registration and there was no mention of the concept of ‘limited liability’. This Act enabled companies to be incorporated by a process of registration, and it established Registrar of Joint Stock Companies to register companies. This Act applied to all joint stock companies with more than 25 members or companies, which permitted transfer of shares without consent of all the members.

Although there was a procedure for proper registration of companies, the concept of limited liability was still unavailable. Shareholders could still be personally liable for the company’s debts and this discouraged many wealthy

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58 Ibid.

59 *United Kingdom Joint Stock Companies Act 1844* (UK).

investors from investing in the UK. The pressure from investors seeking a safer investment led to enactment of the *Limited Liability Act 1885* (UK), which granted companies limited liability for investors.

Since then, the principle of limited liability became firmly established by *Salomon’s* case, which was subsequently applied and affirmed in later cases.

### 3 Benefits of Limited Liability

This segment will discuss the benefits of limited liability to accentuate the importance of limited liability as a principal characteristic of a company.

Firstly, limited liability translates into a potentially win-win scenario for shareholders and directors. The limited liability shield protects directors, being controllers of a company. This means that directors will not be personally liable for the company’s debts unless they breach their duties or deliberately incur debt of the company when it is insolvent. As such, this shield emboldens directors to take higher risks for the company so long as

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61 Malik, above n 57.
62 Carney, above n 60.
64 Lipton, above n 3, 30.
65 Ibid.
these decisions are taken in the best interests of the company. These high risks may also result in high rewards, thereby resulting in a potentially advantageous scenario for shareholders.

Secondly, limited liability transfers risk from shareholders to creditors. If the company profits, the profit will be distributed to the shareholders; however, if the company suffers from any losses, creditors will bear the consequences. Thus, shareholders only lose the amount of shares invested in the company, whereas creditors could lose anything up to the entire value of their investment in, or product or service provided to, the company if the company is unable to repay debts to creditors.

Thirdly, limited liability allows the separation of ownership and management of a company. Shareholders and directors play different roles in the operations of the company. Directors act as an agent for the shareholders to govern the company’s day-to-day operation and they have fiduciary duties to act in the best interests of the company. Directors have better knowledge of the market economy and they are more specialised in making an optimal

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66 Ibid.
71 Lipton, above n 3, 30.
72 Ibid.
decision for the company.\textsuperscript{74} This reduces the need for shareholders to monitor the managers of companies.\textsuperscript{75} Furthermore, the risk to the shareholders of a company’s failure is only limited to the loss of capital invested. Unlike in an unlimited liability company, where shareholders’ personal wealth is at stake, shareholders of limited liability companies do not tend to intrude into the day-to-day management of the company.\textsuperscript{76}

These are the benefits of the principle of limited liability. This principle in which the controllers of the company are only limited to the amount invested flows from the concept of the company being a ‘separate legal entity’, the next concept that will be discussed.\textsuperscript{77} This is because the owners are not liable for their company’s debts since a shareholder and the company are two distinct legal persons.\textsuperscript{78} Hence, limited liability and separate legal entity status principles complement each other.

\textbf{C Separate Legal Entity Status}

This segment will define the principle of ‘separate legal entity’ status and discuss the landmark case, \textit{Salomon's case},\textsuperscript{79} which established the principle of ‘separate legal entity’ status. It is important to define this principle because it is one of the defining characteristics of a company.

\textsuperscript{74} Ibid.
\textsuperscript{75} Ibid
\textsuperscript{77} F Easterbrook and D Fischel, \textit{The Economic Structure of Corporate Law} (Harvard University Press, 1991) 41-44.
\textsuperscript{78} Ibid.
\textsuperscript{79} \textit{Salomon v A Salomon & Co Ltd} [1987] AC 22.
1 Definition

The principle of separate legal entity status establishes that a company is distinguishable from its directors and shareholders. This means that a company can enter into a contract by itself and have its own rights and liabilities. A company’s property is also separate from that of its directors and shareholders. The principle of separate legal entity status automatically comes into effect once a company is registered. The landmark case, Salomon’s is authority for the legal principle that an incorporated company is a separate legal entity from its shareholders, founder and directors.

2 Salomon’s case

Mr Salomon was a boot and shoe manufacturer and he sold his shoe business to a limited liability company, which he had set up with his sons. The shareholders of the company were Mr Salomon, Mrs S and their five children and each of them took one share. Mr Salomon and his two eldest sons were appointed directors. The consideration for the sale of the business was £39,000 which was an excessive price. The purchase price was paid as follows: 20,000 x £1 fully paid up shares, debentures worth £10,000 issued to

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81 Ibid.
82 Ibid.
85 Ibid.
Salomon (the debentures being a secured charge over the company’s assets), £1000 paid in cash to Salomon an £8000 payment in discharge of the debts of the business.\textsuperscript{86}

Business went into decline and Salomon injected more funds, which were apparently insufficient to stabilize the company. He then borrowed £5000 from Edmund Broderip by reissuing the debentures in Broderip’s name. However, the business deteriorated further and eventually the company went into liquidation. The liquidator found that the company’s assets were worth only £6000. £5000 was used to repay Broderip’s claim, and the remaining £1000 was repaid to Salomon, the debenture holder, because the debentures were a secured charge over the company’s assets. After these repayments, there would be nothing left to repay of the £8000 owed to the unsecured creditors.

The liquidator attempted to hold Mr Salomon personally liable as a director for the debts of the company. The liquidator argued that the debentures used by Mr Salomon as a security for the debt were invalid, and that Salomon had committed fraud by deceiving the unsecured creditors with the excessive price of the business. Williams J in the High Court, Vaughan J and the other judges in Court of Appeal ruled against Mr Salomon on the grounds that the company was Mr Salomon’s agent to commit fraud and Mr Salomon as a principal was liable for debts to unsecured directors.\textsuperscript{87}

\textsuperscript{86} Debentures are long-term security yielding a fixed rate of interest, issued by a company secured against assets, \textit{Corporations Act 2001} (Cth) s 9; \textit{Levy v Abercorris Slate and Slab Co} (1887) 37 Ch D 260, 264.

\textsuperscript{87} \textit{Salomon v A Salomon & Co Ltd} [1987] AC 22, 51.
The House of Lords unanimously overturned the decision and held that:

A company is not, per se, the agent of its shareholders, even if control is concentrated in only one shareholder. The mere fact that a person owns all the shares in a company does not make the business carried on by that company his business. Once the company is legally incorporated, it must be treated like any other independent person with rights and liabilities of its own.\(^88\)

In other words, the House of Lords affirmed the legal principle that, upon incorporation, a company is considered as a new legal entity, separate from its shareholders. The company has its own right and liabilities. Therefore, Mr Salomon was not liable for the company’s debts.\(^89\)

3 Post-Salomon’s case

The Salomon’s case established the foundation rule that a company is recognised by law as a legal person with its own rights and liabilities, and not merely an agent of its owners.\(^90\)

Secondly, it established the doctrine that the shareholders are not liable for the company’s debts beyond their initial capital investment, and have no proprietary interest in the company’s properties.\(^91\)

\(^{88}\) Ibid.
\(^{90}\) Ibid.
\(^{91}\) Ibid.
The Salomon’s principle was affirmed in *The King v Portus*,\(^9\) where Latham CJ ruled that the company is a distinct person from its shareholders and the directors who are not personally liable to the creditors for the company’s debts.

This principle is firmly established in the Australian and the Chinese statute.\(^9\) Companies that are formed under the Act and CCL are automatically considered a separate legal entity from its directors and shareholders.

Nevertheless, some directors abuse the principles of separate legal entity and limited liability and in such cases, courts are allowed to pierce the corporate veil and hold them liable for the company’s debts.\(^9\) The circumstances that will allow courts to pierce the corporate veil will be discussed in Chapter II – Directors’ Duties (Insolvent Trading) and Chapter III – Piercing the corporate veil.

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The next segment will provide a brief history and description of piercing the corporate veil to demonstrate an overview and the reason behind the introduction of veil piercing doctrine.

D Piercing the Corporate Veil

1 Definition

Piercing the corporate veil is when a court decides to depart from the principles of separate legal entity status and limited liability to hold directors and shareholders liable for the company’s debts. ⁹⁵

2 Brief History

The principle of piercing the corporate veil can be traced back to Germany in the 1920s. German corporate law developed a number of theories in the early 1920s for lifting the corporate veil. ⁹⁶ As this thesis focuses on current aspects of corporate law, this thesis will only provide a brief history of piercing the corporate law starting with the history of ‘piercing the corporate veil’ shortly after, the landmark case, Salomon’s in the UK.

After the establishment of the limited liability and separate legal entity status principles in Salomon’s case, UK courts affirmed that they would not allow

⁹⁵ Lipton, above n 3, 41.
the abuse of the principles established in *Salomon’s* case. They would not allow the separate identity of a company to be used to avoid any pre-existing liability or for fraud purposes. This was affirmed through a series of cases beginning from 1960s.

*Jones v Lipman* is an example in which the corporate veil is lifted when a company is used as a ‘mere façade’ to avoid a pre-existing obligation. In this case, Lipman breached his contract by failing to sell a property to Jones. Subsequently, Lipman transferred the property to a company, of which he and a nominee were the sole shareholders and directors. The court held that the company that Lipman transferred his property to was a sham and was used to avoid the consequences of his breach of contract. Lipman was held liable and specific performance was ordered against him to perform the contract. Lipman’s company was not considered as a separate legal entity because Lipman’s real purpose of forming the company was to avoid his personal contractual obligation and not for the real purpose of carrying on business.


98 Cheng, above n 94, 328.


100 *Jones v Lipman* [1962] 1 WLR 832.
In the 1970s, the elements of piercing of the corporate veil expanded to include parent companies and subsidiaries. In *DHN Food Distributors v Tower Hamlets LBC*\(^{101}\) and *Woolfson v Stratchlyde Regional Council*\(^ {102}\), the courts again emphasized that it is only appropriate to pierce the corporate veil where circumstances indicate that it is a mere façade concealing true facts.\(^ {103}\)

The next case discussed, *Adams v Cape Industries*,\(^ {104}\) is a leading case in the veil-piercing doctrine because it expands on the grounds that courts can pierce the corporate veil.

*Adams v Cape Industries*,\(^ {105}\) in 1990 affirmed the important elements of veil-piercing doctrine.\(^ {106}\) This leading case in the UK is authority for the factors that can be taken into in piercing the corporate veil: which are discussed below.\(^ {107}\) The Court of Appeal asserted that courts are not free to disregard the principles of separate legal entity status and limited liability just because it considers justice requires it.\(^ {108}\) The decision in *Adams v Cape*\(^ {109}\) is crucial to the understanding of lifting the corporate veil because the Court of Appeal

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101 *DHN Food Distributors v Tower Hamlets LBC* [1976] 1 WLR 852.
102 *Woolfson v Strathclyde Regional Council* [1978] UKHL 5
103 Ibid.
104 *Adams v Cape Industries plc* [1990] 1 Ch 433.
105 Ibid.
107 *Adams v Cape Industries plc* [1990] 1 Ch 433.
108 Sleightholme, above n 106.
discussed three circumstances for piercing the veil: single economic unit, agency and façade.\textsuperscript{110}

This case involved liability within a group of companies. Cape Industries Public Limited Company was a parent company of an international group that mined asbestos in South Africa and were shipped to Texas, where Cape’s subsidiary, NAAC, supplied the asbestos to another company in Texas. NAAC’s employees fell ill, with asbestosis. The claimant, one of the employees, Adams, sought to circumvent the separate legal status within a parent company (Cape) and its subsidiary company (NAAC) to hold the parent company liable for NAAC’s responsibilities.

The court had to determine whether the defendant had a presence in the United States (‘US’) and whether a Texan judgment could be enforced against the entity. The court could not disregard the principles established in \textit{Salomon’s} in the name of justice and rejected the argument that Cape and NAAC should be treated as one entity.\textsuperscript{111} In addition, the Court of Appeal stated the circumstances that a veil may be pierced: single economic unit, agency and façade.\textsuperscript{112} These circumstances will be further discussed in Chapter III – Piercing the Corporate Veil since the circumstances will be compared to another jurisdiction, China.

\begin{flushleft}
\textsuperscript{110} Sleightholme, above n 106.
\textsuperscript{111} Florence Gakungi, ‘The Interpretation of the Doctrine of Piercing the Corporate Veil by the UK Courts is More Successful than by the US Courts’ [2012] 3(2) \textit{King’s Student Law Review} 211, 215.
\textsuperscript{112} \textit{Adams v Cape Industries plc} [1990] 1 Ch 433.
\end{flushleft}
This section lays down the reason the author chose the term ‘piercing’ instead of ‘lifting’ the corporate veil for this thesis.

Australian courts have often mixed the terminology regarding the court’s act of ‘going behind’ the corporate veil to hold directors personally liable, or more specifically, ‘piercing’ or ‘lifting’ the corporate veil.

The English courts expressly distinguish the meaning of ‘piercing the corporate veil’ from ‘lifting the corporate veil’. Staughton LJ, in *Atlas Maritime Co SA v Avalon Maritime Ltd (No 1)* stated:

To *pierce* the corporate veil is an expression that I would reserve for treating the rights and liabilities or activities of a company as the right or liabilities or activities of its shareholders. To *lift* the corporate veil or *look behind* it, on the other hand, should mean to have regard to the shareholding in a company for some legal purpose.

The distinction between these two phrases is not strictly followed in Australia, where these two phrases are often mixed up in the courts. Young

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113 See for example, *Commissioner of Land Tax v Theosopical Foundation Pty Ltd* (1966) 67 SR (NSW) 70 (NSWCA, Herron CJ, Sugerman and McLelland JJA).
115 Ibid.
J, in *Pioneer Concrete Services Ltd v Yelnah Pty Ltd*, defined the expression “lifting the corporate veil” as ‘that although whenever each individual company is formed a separate legal personality is created, courts will on occasions, look behind the legal personality to the real controllers’.

In other words, Young J suggested that courts might refer to “lifting” the corporate veil at anytime they want to examine the operating mechanism behind a company. ‘Piercing’ the corporate veil is used to hold a person liable for company’s debts or liabilities.

This thesis examines veil-piercing doctrine that acts as a mechanism for creditors to pursue any corporate abuse by directors or shareholders. Therefore, the phrase ‘piercing the corporate veil’ has more effect in conveying this thesis’ aim in analysing laws on veil-piercing doctrine, which allow courts to hold shareholders or directors personally liable.

**Summary of Chapter I – Introduction**

This Chapter has explained the objective of this thesis which is to determine which jurisdiction, Australia or China, has better veil piercing laws that protects creditors’ interest. The discussion of veil piercing laws in Australia

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117 (1986) 5 NSWLR 254.
118 *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 5 NSWLR 254, 264.
119 Ramsay, above n 73, 252.
and China will be in Chapter II – Directors’ Duties (Insolvent Trading) and Chapter III – Piercing the Corporate Veil.

This Chapter also defined the meaning of ‘corporation’ and ‘company’ under the Act and CCL. There is also an explanation of types of limited liability companies that are allowed to be incorporated under the Act and CCL. The explanation illustrates the types of companies that are considered limited liability under the Act and CCL and it is important to highlight that the types of companies in Australia and China are distinct from one another and also differ in characteristics.

Further, this Chapter has laid the foundation of the basic principles of a company, namely the principles of limited liability and separate legal entity status, by providing the relevant definitions, history and also illustrating the landmark case, Salomon’s case, which is associated with these principles. It is essential to lay down the foundation of these principles as piercing the corporate veil doctrine is linked to them.

Furthermore, this chapter has also explained the reason courts are allowed to pierce the corporate veil by briefly explaining its history and some of the cases that help to affirm veil-piercing doctrine. This segment was included in this Chapter to demonstrate an overview of the veil piercing doctrine.

The next Chapter, Directors’ Duties: Creditors’ Interest (Insolvent Trading) will focus on directors’ duties in relation to creditors’ interests in both jurisdictions and the implications for the veil piercing doctrine. It also
includes a comparison between both jurisdictions regarding insolvent trading and directors’ duties.
II DIRECTORS’ DUTIES (INSOLVENT TRADING)

A Introduction

This Chapter will discuss a director’s duties in relation to creditors’ interests in Australia and China. The focus of this Chapter will be a director’s duty to prevent insolvent trading since a breach of this duty will often affect creditors’ interests and a discussion on the duty is vital since a breach of this duty will usually allow the court to pierce the corporate veil.¹²¹

This Chapter will first discuss Australia’s directors’ duties relating to the laws on insolvent trading. The discussion then shifts to China, which examines directors’ duties under the CCL and statutory insolvent trading laws under the Chinese Bankruptcy Law (‘CBL’) since the CCL does not provide any provisions regarding insolvent trading. It is essential to first discuss directors’ duties because they underpin the basic responsibility of a director in a company, which are related to a director’s duty to prevent insolvent trading. Therefore, the director’s fiduciary duties that will be discussed are the ‘duty to act in good faith and in the company’s best interests’

This Chapter will also examine the insolvent trading laws of the US because China has insufficient primary and secondary sources discussing insolvent trading laws.¹²² The US is a suitable replacement in lieu of China because the

¹²¹ Lipton, above n 3, 489.
CBL, as will be shown, is modelled on the US common law regarding a director’s duty to prevent insolvent trading.\textsuperscript{123}

After examining the directors’ duties regarding insolvent trading laws, there will be two comparisons - Australia with China and Australia with the US. The comparisons are made to analyse which jurisdiction provides better creditor protection in relation to insolvent trading and it will be argued that Australia has better insolvent trading laws than China and the US in this respect.

The next segment will examine directors’ duties in Australia regarding insolvent trading in Australia.
This segment will concentrate on Australian directors’ duty to prevent insolvent trading. Directors have a duty to prevent the company from trading while insolvent. If a director breaches this duty, the company’s creditors may sue him or her and the courts may hold him or her personally liable.\textsuperscript{124}

This segment first examines a director’s fiduciary duties before extending into a director’s duty to prevent insolvent trading. It is important to first examine a director’s fiduciary duties because it forms the underlying commitment that a director owes to a company, and they extend to the duty to prevent insolvent trading.

\textbf{1 Fiduciary Duties}

Directors’ duties are governed by the Act and case law.\textsuperscript{125} Directors owe fiduciary duties to their companies, which have developed through case law and are reinforced by legislation.\textsuperscript{126} A fiduciary duty in this context is an

\textsuperscript{124} \textit{Corporations Act 2001} (Cth) s 588G.
\textsuperscript{126} A director of a company is defined as a person who is appointed to the position of a director or alternate director regardless of the name given to their position, \textit{Corporations Act 2001} (Cth) s 9; \textit{Corporations Act 2001} (Cth) 2001 ss 180-184; \textit{Bristol and West Building Society Mothew [1998] Ch 1 Millett; Greenhalgh v Ardene Cinemas Ltd [1951] Ch 286; Walker v Wimborne (1976) 137 CLR 1; Vines v ASIC [2007] NSWCA 75; Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 281; Aberdeen Railway Co v Blaikie Bros (1854) 1 Macq 461; South Australia v Clark (1996) 66 SASR 199; ASIC v Rich [2003] NSWSC 85.
equitable duty to act in good faith for the benefit of another.\textsuperscript{127} Directors are not permitted to profit from their position or to put themselves in a position where their fiduciary duties and their personal interests may conflict.\textsuperscript{128}

This includes a duty of loyalty.\textsuperscript{129} In \textit{Bristol and West Building Society v Mothew}, Millett LJ explained the concept of ‘loyalty’:

\begin{quote}
The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or for the benefit of a third person without the informed consent of his principal…\textsuperscript{130}
\end{quote}

Thus, the Court has expressly laid down four main principles of fiduciary duties. The four main principles of fiduciary duties are firstly, to act in good faith and in the best interests of the company, secondly, to exercise directors’ powers for proper purposes, thirdly, to retain their discretionary powers and lastly, to avoid any undisclosed conflicts of interests.\textsuperscript{131} These common law

\textsuperscript{127} \textit{Hospital Products Ltd v United States Surgical Corp} (1984) 156 CLR 41.
\textsuperscript{128} Ibid.
\textsuperscript{129} \textit{Bristol and West Building Society v Mothew} [1998] Ch 1.
\textsuperscript{130} Ibid 18.
\textsuperscript{131} Directors’ duty to retain their discretion means directors must not place themselves in a position where they are unable to make decisions in the best interests if the company, PricewaterhouseCoopers, ‘A Guide to Directors’ Duties and Responsibilities for Non-Listed Public Companies and Proprietary Companies in Australia’ (Research Paper, April 2008) 3; \textit{Bristol and West Building Society v Mothew} [1998] Ch 1.
duties are supplemented by statutory duties.\textsuperscript{132} This segment will focus on the ‘duty to act in good faith and in the company’s best interests’ as this duty encompasses a director’s duty to prevent insolvent trading.\textsuperscript{133}

The following segments will first discuss a director’s duty of act in good faith and in the company’s best interests.

\textit{(a) Good Faith and in the Company’s Best Interests}

As mentioned above, directors have a fiduciary and statutory duty to act in good faith and in the best interests of the company.\textsuperscript{134} The test as to whether a director has acted in good faith and in the company’s best interests is an objective test.\textsuperscript{135}

This test is a ‘reasonable person test’ and it requires an honest person in the position of a director to have reasonably believed that his or her conduct was in the best interests of the company.\textsuperscript{136} Owen J in \textit{Bell Group Ltd (in liq) v


\textsuperscript{133} Lipton, above n 3, 489.

\textsuperscript{134} Corporations Act 2001 (Cth) s 181(1).


\textsuperscript{136} \textit{Cambridge Corporation Ltd v Lyods Bank Ltd} (1970) Ch 62; \textit{Farrow Finance Company Ltd (in liq) v Farrow Properties Pty Ltd (in liq)} (1997) 26 ACSR 544; \textit{A Ltd v Rambaldi} [2011] VSCA 392.\end{footnotesize}
Westpac Banking Corp (No 9)\textsuperscript{137} noted that a director’s management decision is not reasonable:

if, on consideration of the surrounding circumstances, the assertion of directors that their conduct was bona fide in the best interests of the company and for proper purposes should be doubted, discounted or not accepted’.\textsuperscript{138} This has been affirmed on appeal in Westpac Banking Corp v Bell Group Ltd (No 3).\textsuperscript{139}

The issue remains as to the actual meaning of ‘best interests of the company’. Courts take the fundamental view that the duty to act in good faith and in the best interests of the company also includes the interests of shareholders as a whole unit.\textsuperscript{140}

However, the definition of ‘best interests of the company’ is ‘ever-changing’.\textsuperscript{141} When a company is solvent, a director is required to have regard to the interests of the shareholders as well as to the interests of the company as a commercial entity.\textsuperscript{142} When a company is insolvent or going into insolvency, a director is required to consider the company’s present and future creditors’ interests.\textsuperscript{143}

\textsuperscript{137} [2008] WASC 239.
\textsuperscript{138} Westpac Banking Corp v Bell Group Ltd (No 3) [2012] WASCA 157.
\textsuperscript{140} Darvall v North Sydney Brick and Tile Co Ltd (No 2) (1987) 6 ACLC 154
\textsuperscript{141} Ibid.
\textsuperscript{142} Ibid.
In *Nicholson v Permakrat (NZ) Ltd (in liq)*, Cooke J noted that a director may be required to consider the interests of the company’s existing creditors if he or she knew ought to have known that a payment made by the company is likely to jeopardise the company’s solvency.\(^{144}\) His Honour suggested that it was possible that creditors might have an action against directors for a breach of duty of care or negligence in appropriate circumstances.\(^{145}\)

This fiduciary duty is crucial to a to prevent insolvent trading as it obligates a director to consider creditors’ interests at certain points in time (when a company is insolvent or near insolvency). Thus, it protects creditors’ interests. A director will be personally liable for the creditors’ injury if he or she disregards creditors’ interests at or near insolvency.\(^{146}\)

Now that it has been established that the law places a duty upon directors to prevent insolvent trading, this next segment will discuss about the nature and scope of that duty.

2 *Directors’ Duty to Prevent Insolvent Trading*

This segment will explain insolvent trading and describe the circumstances in which a director must prevent insolvent trading. There will also be a discussion on the consequences if this duty if breached, however only


\(^{145}\) Ibid.

\(^{146}\) Ibid.
compensation orders will be discussed as these are the consequences most directly related to creditors’ interests.

A company is insolvent when it is unable to pay all its debts as and when debts become due and payable.\(^\text{147}\) When a company is insolvent, a director is required to place the creditors’ interests above the shareholders’.\(^\text{148}\) For example, a director has to pay off the company’s debts before distributing any payments to its shareholders.\(^\text{149}\) A director is also not allowed to transfer the company’s property or dispose of its assets for less than commercial value because such actions will decrease the size of the pool of assets that are available to pay the company’s outstanding debts and will prejudice the interests of the company’s creditors.\(^\text{150}\) Thus, directors are subjected to the fiduciary duty not to engage in activities that will prejudice creditors’ interests when a company is in financial difficulties.\(^\text{151}\)

Insolvent trading occurs when a director incurs debt at a time when the company is insolvent (or pushed by the debt into insolvency),\(^\text{152}\) when there

\(^{147}\) Corporation Act 2001 (Cth) s 95A.


\(^{150}\) Lipton, above n 3, 489.

\(^{151}\) Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) [2012] WASCA 157.

\(^{152}\) Debt is defined as an obligation by one person to pay a sum of money to another, Powell v Fryer [2001] SASC 59.
are reasonable grounds for suspecting insolvency.\textsuperscript{153} Directors are under a statutory duty to prevent insolvent trading.\textsuperscript{154}

Section 588G of the Act imposes a statutory obligation on directors to prevent insolvent trading as directors control the overall management of the company and have the power to prevent debts from being incurred.\textsuperscript{155}

Olsson J in \textit{Powell v Fryer} also noted that to declare a company insolvent must also be based on its financial circumstances.\textsuperscript{156} His Honour stated:

\begin{quote}
The conclusion of insolvency must be derived from a proper consideration of the Company’s financial position, in its entirety, based on commercial reality. Generally speaking, it ought not to be drawn simply from evidence of a temporary lack of liquidity. Regard should be had not only to the Company’s cash resources immediately available, but also to money, which it can procure by realization by sale, or borrowing against the security of its assets, or otherwise reasonably raise from those associated with, or supportive of, it. It is the inability, utilizing such resources as are available through the use of assets or which may otherwise realistically be raised through the use of assets or which may otherwise realistically be raised to meet debts as they fall due which indicates insolvency.\textsuperscript{157}
\end{quote}

\begin{footnotes}
\item[153] \textit{Corporation Act 2001} (Cth) s 588G(1).
\item[154] Ibid s 588G.
\item[155] Lipton above n 3, 497.
\item[156] \textit{Powell v Fryer} [2001] SASC 59, 111.
\item[157] Ibid.
\end{footnotes}
Thus, insolvency is determined by a company’s circumstances as well as its inability to pay its debts.  

Directors breach section 588G of the Act if they fail to prevent the company from incurring debt when they have a reasonable grounds to suspect that the company was insolvent at the time the debt was incurred. The term ‘reasonable’ in this context was defined in ASIC v Plymin, where a director of reasonable competence and diligence is expected to be capable of reaching a reasonably informed opinion as to the company’s financial capacity.

Chesterman J in Williams v Scholz identified some of the circumstances in which a director can reasonably suspect a company is insolvent. Some examples include trading unprofitably and accumulating losses continuously or when the company’s overdraft facility is frequently exceeded.

Once the directors have reasonable grounds to suspect insolvency, they have a duty to prevent the company from incurring debt. Failure to do so is a breach of section 588G(2) of the Act. Justice Mandie in ASIC v Plymin (‘Water Wheel case’) case noted:

A non-executive director is expected to take steps to put himself in a position to monitor the company and to exercise and form an independent judgment and to take a diligent and intelligent interest in the information.

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159 Corporations Act 2001 (Cth) s 588G(1)(c).
160 [2003] VSC 123.
162 Williams v Scholz [2007] QSC 266.
163 Ibid.
164 Corporations Act 2001 (Cth) s 588G(2).
165 ASIC v Plymin [2003] VSC 123.
either available to him or which he might with fairness demand from the executives or other employees and agents of the company.\textsuperscript{166}

The Court held that if the director was aware of facts which would cause a reasonably competent non-executive director to suspect that the company was insolvent at the time it incurred a debt, section 588G(2) will be breached\textsuperscript{167}

A breach by a director of section 588G may also be a breach of section 181 of the Act (duty of good faith and to act in the best interests of the company) because a director has arguably not acted in the best interests of the company.\textsuperscript{168} A director in this instance knowingly allows the company to end up in a poor state, saddled with debt or insolvent and has also arguably not regarded the creditors’ interests because the ability of the company to repay its debts has been reduced.\textsuperscript{169}

\textit{(a) Consequences of Contravention}

This segment will discuss the consequences which a director may face if he or she breaches section 588G of the Act. There are several consequences: the court may order a director to pay compensation or disqualify the director from managing companies or impose a criminal penalty (punishable by fine

\textsuperscript{166} Ibid 560.
\textsuperscript{167} ASIC v Plymin [2003] VSC 123.
\textsuperscript{168} Philip Lipton, Abe Herzberg and Michelle Welsh, \textit{Understanding Company Law} (Thomson Reuters, 17\textsuperscript{th} ed, 2014) 497; Anil Hargovan and Jason Harris, ‘Before the High Court for Whom the Bell Tolls: Directors’ Duties to Creditors after Bell’ (2003) \textit{Sydney Law Review} 433.
or imprisonment) or other civil penalty orders.\textsuperscript{170} This segment will only focus on the compensation orders as the thesis’ main focus is on creditors and the director being personally liable to the company’s creditors.

A compensation order is a civil penalty to compensate the creditors for damages caused by a director’s breach.\textsuperscript{171} Compensation orders under sections 588J or 588K may be made whether or not the company is in liquidation.\textsuperscript{172} Unsecured creditors can make a claim against a director through the liquidators.\textsuperscript{173} In circumstances where liquidators fail to launch an action or a liquidator consents to the creditor’s application to launch an action, creditors are given a right to initiate their own compensation claims against a director.\textsuperscript{174}

Under sections 588J, 588K and 588M of the Act, a director is liable to pay compensation equal to the amount of loss or damage suffered by all unsecured creditors whose debts were incurred in contravention of section 588G due to the company’s insolvency.\textsuperscript{175} Secured creditors may also claim compensation from a director if they are able to prove that the unsecured debts were incurred when the company was insolvent.\textsuperscript{176}

\textsuperscript{170} Other Civil penalty orders include a declaration under section 1317E of \textit{Corporations Act 2001} (Cth) (‘the Act’), a pecuniary order (section 1317G of the Act), a refund order (section 1317GA of the Act); \textit{Corporations Act 2001} (Cth) ss 588J, 588K, 206C.
\textsuperscript{171} Australian Securities and Investment Commission, ‘Directors- Consequences of Insolvent Trading’ (Working Paper, Australian Securities and Investment Commission); \textit{Corporations Act 2001} (Cth) s 171H.
\textsuperscript{172} \textit{Corporations Act 2001} (Cth) ss 588J and 588K.
\textsuperscript{173} Ibid s 588S.
\textsuperscript{174} Ibid s 588M(3).
\textsuperscript{175} Ibid ss 588J, 588K and 588M.
\textsuperscript{176} The debts incurred at the time the company was insolvent does not have any security, for example mortgage, will be considered as unsecured, \textit{Corporations Act 2001} (Cth) s 588D.
Secured creditors can only recover their debts from a company that was trading while insolvent once all the company’s unsecured debts have been paid in full. This is because insolvent trading has a bigger impact on unsecured creditors since they do not have any secured interests over any of the company’s assets and the debts were incurred when the director knew the company was insolvent.\(^{177}\)

In conclusion, directors in Australia have a fiduciary duty regarding insolvent trading and if they incur debts when a company is insolvent or near insolvency, they will be not be able to hide behind the corporate veil and will be personally liable to compensate creditors.\(^{178}\) Thus, the laws are clear on a director’s duty regarding insolvent trading and arguably provide a fairly high degree of protection for creditors.\(^{179}\)

The discussion now shifts to China, where a director’s duties will be examined.

_C Directors’ Duties in China_

This segment focuses on a Chinese director’s duty to prevent the company from bankruptcy because a violation of these duties may result in the director being personally liable to the creditors.\(^{180}\) In China, the term ‘bankruptcy’ in

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\(^{179}\) _Corporations Act 2001_ (Cth) s 588G.

\(^{180}\) _[Enterprise Bankruptcy Law of the People’s Republic of China]_ (People’s Republic of China) National People’s Congress, Order No 54, 1 June 2007, art 125.
the context of companies means being insolvent.181 This segment will first discuss a director’s duties in China which are the ‘duty of loyalty’ and the ‘duty of care’ followed by a director’s duty to prevent the company from bankruptcy.

Unlike in Australia, China’s directors’ duties are fully codified in the CCL.182 However, the CCL does not explain the meaning of these duties. 183 The concepts of ‘duty of loyalty’ and ‘duty of care’ in China are based on a principal-agent relationship where agents are loyal to their principal and have duties to exercise their powers in good faith and good care.184 In order to grasp the definition of these concepts, one must look to secondary sources.185 Directors in China are thus effectively agents and are required to actively discharge their duties of good faith and care and to place their company’s (principal’s) interests above their personal interests.186

Best interests of a company in China also include shareholders’ interests.187

The CCL sets out the duties of a director to ensure that they act in the

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181 Ibid.
183 Ibid art 148.
187 [Provisions on the Administration of the Registration of the Legal Representatives or Designated Legal Representative of Enterprise Legal Persons] (People’s Republic of China)
shareholders’ interests.\footnote{\textit{Company Law of the People’s Republic of China} (People’s Republic of China) National People’s Congress, 27 October 2005, arts 148, 149, 150, 151, 152 and 153.} However, during bankruptcy, directors are under a statutory obligation to not damage creditors’ interests and they must focus on the creditors’ interests and fulfil a duty of care when the company is bankrupt.\footnote{\textit{Enterprise Bankruptcy Law of the People’s Republic of China} (People’s Republic of China) National People’s Congress, Order No 54, 1 June 2007, art 125.} Similar to Australia, as noted above, a director’s duty to act in the best interests of the company in China changes depending on the company’s financial status.\footnote{\textit{Ibid.}} When a company is solvent, a director’s primary interests are the shareholders’ interests but when the company is bankrupt, creditors’ interests takes priority over shareholders’ interests.\footnote{\textit{Ibid.}}

The thesis will now further discuss the nature and scope of the duty of care and the duty of loyalty which are specifically set out in the CCL.

1 \textit{Duty of Loyalty}

CCL does not define the ‘duty of loyalty’.\footnote{\textit{Company Law of the People’s Republic of China} (People’s Republic of China) National People’s Congress, 27 October 2005, arts 116, 148 and 149.} Rather, CCL only prohibits a director from acts related to bribery, misappropriation of company assets or funds, abuse of position and power and breaches of confidentiality.\footnote{\textit{Ibid.}} However, this thesis will not discuss each prohibitory act because they are not related to the thesis topic.
The thesis will now discuss a director’s ‘duty of care’. This duty is essential because a director must exercise reasonable care to ensure that insolvent trading does not occur.

2 Duty of Care

Article 148 of the CCL does not provide any definitions or guiding principles regarding this duty. Yousu Zhou, an academic, suggests a definition for this duty as follows:

The duty of care, also known as the duty of good management or duty of attention, means that the directors, supervisors and senior management executives shall exercise the rights granted by the company prudently, seriously and diligently, and act with the kind of prudence, care and diligence and skill that a reasonably prudent person would behave like under similar circumstances.

Various leading academics in corporate law have adopted this definition of the duty of care. Despite this, there is no conclusive or settled definition of directors’ duty of care in China. Fortunately, there have been some judicial

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194 Ibid art 148.
comments regarding the definition of duty of care which may offer at least some guidance. Two judges of the Supreme People’s Court (‘SPC’), Judge Xi and Judge Jin in their academic writings noted that Chinese courts have adopted the ‘three-criteria of the duty of care decided in the case law of Anglo-American countries’.\(^{198}\)

The first criterion is that a director must act in good faith.\(^{199}\) The test for good faith is different from Australia because it is based on a subjective test in China whereas Australia applies an objective test as noted above.\(^{200}\) This subjective test requires a director to reasonably believe that he or she was acting in good faith in the best interests of the company at the time they committed the alleged wrongdoing.\(^{201}\) An important factor would be whether the director understood the consequences of their actions and had bothered to take due care to ensure that negative consequences would not ensue.\(^{202}\) If a director understood that his or her actions would be detrimental to the company’s interests but did not take positive steps to ensure that the detrimental would not occur, this test of good faith will not have been satisfied.\(^{203}\) This test requires honest intent; a director cannot be disingenuous and say that they believed in a certain state of affairs when privately they

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\(^{198}\) Wang, above n 41,209.

\(^{199}\) Ibid.


\(^{201}\) Wang, above n 41, 209.


\(^{203}\) Xi, above n 200, 468.
knew this was not the case, so are really only looking for a ‘convenient excuse’. 204

The second criterion is care. 205 Directors must carry out their duty commensurate with the standard expected of someone with their professional qualifications and experience. 206 Thus, while the first criterion involved a subjective test, there is an element of objectivity in this criterion in the manner in which directors act on such beliefs (which is to act as other professionals would). 207

The last criterion is reasonable belief. 208 Directors need to reasonably believe that their actions are in the best interests of the company. 209 Therefore, it is not enough for directors to have had honest beliefs (the first criterion); such beliefs must also have been reasonable, judged by objective standards (similar to those outlined in the second criterion). 210

If directors are able to satisfy all of the criteria above, they are considered to have complied with their obligation of duty of care to the company. This duty is essential because a director must exercise reasonable care to ensure that insolvent trading does not occur, or that if it does, they are not held personally responsible for it. The next segment discusses insolvent trading laws in China.

204 Ibid.
205 Ibid.
206 Wang, above n 41, 209.
207 Ibid.
208 Ibid.
209 Xi, above n 200, 469.
210 Ibid.
3 Insolvent Trading in China

The CCL does not deal with insolvent trading and only expresses that directors owe a duty to creditors when the company is in liquidation and not when it is near bankruptcy.\textsuperscript{211} As stated above, the CBL governs insolvent trading laws in China.\textsuperscript{212} Thus, this segment’s discussion of insolvent trading laws will shift from the CCL to the CBL.

A company is considered bankrupt if it is unable to pay its debts to its creditors when they are due and its assets are unable to pay off its debts or they are illiquid under Article 2 of CBL.\textsuperscript{213} Article 125 of the CBL places several safeguards against insolvent trading by directors.\textsuperscript{214} Firstly, directors who violate the duties of care and who were not honest during trading which resulted in the company’s bankruptcy shall be liable for the damage caused to the company’s creditors.\textsuperscript{215} Secondly, the offending director(s) will not be allowed to hold any directorial position for three years.\textsuperscript{216}

However, the CBL only states that directors are liable for leading the company into bankruptcy but is silent as to the circumstances that would amount to leading the company into bankruptcy.\textsuperscript{217} There is also dearth of

\begin{footnotes}
\item[211] [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 27 October 2005, art 191.
\item[212] [Enterprise Bankruptcy Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 54, 1 June 2007, art 125, 128.
\item[213] Ibid art 2.
\item[214] Ibid art 125.
\item[215] Ibid.
\item[216] Ibid.
\end{footnotes}
case and academic discussion on this issue and there are very few cases
where directors have been held liable.218

Insolvent trading laws in China are governed by the CBL but there is a dearth
of academic discussion on directors’ duty during insolvency to protect
creditors’ interests.219 Therefore, for the purpose of analysing which laws
provide better creditors protection, the author will look to US’s insolvency
laws since CBL is considered to be modelled on the US’s insolvency laws as
discussed below.220

Bankruptcy law through the Lens of UNICITRAL Legislative Guide to Insolvency Law’
218 The lack of discussion could be due to lack of cases in this area of law. The author
suggests the reason to this is because suing directors might undermine the state authority
since SOE still tightly controls and influences China’s company’s decisions. SOE still owns
shares in most of the JSCs in China, Shuanmei Wen, ‘The Ideals and Reality of A Legal
Transplant – The Veil- Piercing Doctrine in China’ (2014) 50 Stanford Journal of
International Law 319, 335; John J Rapisardi and Binghao Zhao, ‘A Legal Analysis and
Practical Application of the PRC Enterprise Bankruptcy Law’ (2010) 11(1) Business Law
International 49, 53; Roman Tomasic, ‘The Conceptual Structure of China’s New Corporate
Bankruptcy Law’ in China’s New Enterprise Bankruptcy Law (Ashgate, 2010) 15; Steven J
Arsenault, ‘The Westernization of Chinese Bankruptcy: An Examination of China’s New
Corporate Bankruptcy law through the Lens of UNICITRAL Legislative Guide to
219 John J Rapisardi and Binghao Zhao, ‘A Legal Analysis and Practical Application of the
PRC Enterprise Bankruptcy Law’ (2010) 11(1) Business Law International 49, 53; Roman
Tomasic, ‘The Conceptual Structure of China’s New Corporate Bankruptcy Law’ in China’s
220 Steven J Arsenault. ‘ The Westernization of Chinese Bankruptcy: An Examination of
China’s New Corporate Bankruptcy Law through the Lens of UNICITRAL Legislative
55; Mary Swanton, Bankruptcy: China Passes Its First Unifies Bankruptcy Law (Inside
Counsel, 2006) 68; Konstantin Hoppe, ‘ Bankruptcy Law in China’ (Research Paper, Eiger,
2009) 23; Nathalie Martin, ‘The Role of History and Culture in Developing Insolvency
and Comparative Law Review 1, 53; Shu-Ching Jean Chen, ‘China’s Bankruptcy Big Bang’,
Forbes (online), 6 December 2007 < http://www.forbes.com/2007/06/12/china-bankruptcy-
law-face-markets-cx_jc_0612autofacescan01.html>; Minkang Gu, Understanding Chinese
Company Law (Hong Kong University Press, 2nd ed, 2010) 326.
D Insolvent Trading in the United States

As Ferinerman, an academic, has noted, Article 125 of the CBL was adopted from the US’s common law model of directors’ duty of good faith (duty to be honest) when a company is near bankruptcy. It states:

Where a director, supervisor or senior manager going against his obligations, fails to be honest and hardworking, which leads to bankruptcy of the enterprise where he works, he shall bear civil liability according to the law.

This provision is based on the US’s deepening insolvency theory whereby a director is required to be honest when presenting his or her company’s financial records to creditors when the company is near insolvency. The director is liable if he or she fraudulently prolongs the company’s life by misrepresenting the company’s financial situation to creditors in order to acquire more funds.

Since Article 125 is based on the US model, this thesis will look at the US’s insolvency laws and compare their insolvent trading provisions with Australia’s. In the US’s context, the term ‘corporation’ refers to ‘company’.

In the US, there is no legislation governing liabilities for directors on insolvent trading.\textsuperscript{225} The common law doctrine of ‘deepening insolvency’ in the US is used to hold directors liable for improperly prolonging the life of an insolvent corporation.\textsuperscript{226} This doctrine, however, is not applicable to all the US’s states.\textsuperscript{227} The author will focus on the state of Pennsylvania because a meta-analysis of all fifty states is beyond the scope of this thesis. In addition, the doctrine of deepening insolvency was first recognised in this state through its landmark case, \textit{Official Committee of Unsecured Creditors v R F Lafferty and Co}, 267 F 3d 340 (3rd Circuit, 2001) (‘\textit{Lafferty}’).\textsuperscript{228}

‘Deepening insolvency’ means the fraudulent prolongation of a corporation’s life beyond insolvency. In \textit{Corporation Aviation Concepts v Multi-Service Aviation Corporation}, it was stated that:

\begin{itemize}
  \item Please note that deepening insolvency laws does not apply in all states, for example Delaware, Lauren Colasco, ‘Where were the Accountants? Deepening Insolvency as A Means of Ensuring Accountants’ Presence When A Corporate Turmoil Materializes’ (2009) 78(2) \textit{Fordham Law Review} 793, 826.
\end{itemize}
Deepening insolvency occurs where corporate property is injured through the fraudulent or concealed expansion of corporate debt and prolongation of corporate life… This tort rests upon the theory that a corporation, even when insolvent, can have valuable corporate property, the fraudulent incurrence of additional debt, however, can damage that value by hastening bankruptcy, undermining business relationships, and dissipating corporate assets.\textsuperscript{229}

Under the deepening insolvency theory, directors may be held liable if the directors and/or officers expand their corporate debt and prolong the life of a corporation when the corporation should be declared insolvent.\textsuperscript{230} This is because the continued operation of a corporation has the effect of increasing losses and deepening the corporation’s insolvency, thereby further reducing the value of the corporate’s assets and injuring the creditors.\textsuperscript{231}

\textsuperscript{229} Corporate Aviation Concepts v Multi-Service Aviation Corporation, 2004 WL 1900001 (ED Pa, 2004).

\textsuperscript{230} Directors want to prolong the life of a company when it should be declared insolvent because the directors believe that the company can continue to operate for another period of time, William L Meyer, ‘Liability of Directors and Officers under the Deepening Insolvency Theory’ (Working Paper No 10, Smith, Gambrell and Russell LLP, 2004) 1; Official Committee of Unsecured Creditors v R F Lafferty and Co, 267 F 3d 340 (3rd Circuit, 2001); Askanase v Fatjo, 828 F Supp 461 (SD Tex 1993); Official Committee of Unsecured Creditors v Credit Suisse First Boston (In re Exide Techs Inc), 299 BR 732 (Bankr D Del, 2003).

If a director borrows additional funds or conceals the corporation’s true financial position which deepens the business’ insolvency, he or she may be liable for this breach.232

The leading case recognising insolvency as an independent cause of action is the Third Circuit’s decision in the abovementioned case of *Lafferty*.233 In *Lafferty*, there were two lease-financing corporations alleged to have operated as a ‘Ponzi scheme’. Both went into insolvency leaving numerous investors with significant losses.234 To operate the scheme, the corporations issued fraudulent debt certificates which were then sold to individual investors. In order to keep the scheme afloat, the management misstated the corporations’ financial positions so that they could register, offer and sell additional debt certificates to raise capital. The issuance of debt securities deepened the insolvency of the corporations and put them on the path to insolvency. When the corporations lost any reasonable prospect of repaying their outstanding debt, they filed for insolvency. The Creditors Committee then brought claims against the management (officers and directors) and third party professionals.

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234 ‘Ponzi scheme’ is a financial arrangement where the Ponzi operator, without legitimate underlying business, makes payments to past investors with funds collected from new investors, Kirkland and Ellis LLP, ‘In the Wake of Collapse: Approaches to Ponzi Scheme Litigation’ (Working Paper, Kirkland and Ellis LLP, 2009).
(lawyers, accountants and independent underwriters) who were responsible for professional advice which supported the securities’ registration.

The Supreme Court in Pennsylvania held that deepening insolvency constituted a valid cause of action. The Court stated that:

Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example… the incurrence of debt can force an insolvent corporation into bankruptcy…235

The Court also stated that a number of courts have held that deepening insolvency may give rise to a perceptible injury to the corporation, which fraudulently disadvantages creditors.236 Hence, deepening insolvency is an eligible cause of action against directors and third parties.237

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236 Official Commissioner of Unsecured Creditors v Credit Suisse First Boston (In re Exide Technologies Inc), 299 B R 732 (Bankr D Del, 2003); Official Commissioner of Unsecured Creditors v. Foss (In re Felt Mfg. Co Inc), 371 B R 589 (Bankr DNH, 2007); OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp), 340 B R 510 (Bankr D Del, 2006); Stanziale v Pepper Hamilton LLP (In re Student Fin Corp), 335 B R 539, 548 (Bankr D Del, 2005), Miller v Dutil (In re Total Containment Inc), 335 B R 580, 619 (Bankr ED Ps, 2005).
237 Official Commissioner of Unsecured Creditors v Credit Suisse First Boston (In re Exide Technologies Inc), 299 B R 732 (Bankr D Del, 2003); Official Commissioner of Unsecured Creditors v. Foss (In re Felt Mfg. Co Inc), 371 B R 589 (Bankr DNH, 2007); OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp), 340 B R 510 (Bankr D Del, 2006); Stanziale v Pepper Hamilton LLP (In re Student Fin Corp), 335 B R 539, 548 (Bankr D Del, 2005), Miller v Dutil (In re Total Containment Inc), 335 B R 580, 619 (Bankr ED Ps, 2005).
There are several requirements to establish deepening insolvency as a cause of action: i) fraud, ii) which prolongs the life of the corporation and iii) which causes the expansion of corporate debt.  

Fraud is an important element to establish deepening insolvency because the creditors will be misled by false representations of solvency, and are induced into making loans to the insolvent company. 

The second element is the prolongation of corporate life. Artificial prolongation of corporate life occurs when a corporation’s life is prolonged when it is supposed to be declared insolvent. If the corporate life of a company is artificially prolonged after the creditors agreed to provide loans, the creditors may be able to sue directors under deepening insolvency. 

The last element is the expansion of corporate debt. There must be evidence which demonstrates that the corporation has expanded its corporate debt if creditors have agreed to provide loans to the company. Plaintiffs

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239 In Official Committee of Unsecured Creditors v Baldwin (In re Lemington Home for the Aged), 659 F 3d 282 (3rd Cir, 2011).

240 Ibid.

241 OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp), 340 B R 510, 534-35 (Bankr D Del, 2006).

242 Ibid.

243 Stanziale v Pepper Hamilton LLP (In re Student Finance Corporation), 335 B R 539, 547-48 (D Del, 2005).

(creditors) can prove this element by showing to the court, financial report of the corporation.\textsuperscript{245}

However, the element of fraud in deepening insolvency is unclear.\textsuperscript{246} There are cases which have asserted that ‘fraud’ is one of the elements whereas there are other cases which state that fraud is not necessarily required to prove deepening insolvency.\textsuperscript{247} In \textit{Seitz}, the Third Circuit in Pennsylvania, limited the scope of deepening insolvency to situations in which the defendants engaged in fraud, which means ‘fraud’ on the part of directors has to be present in order to prove deepening insolvency.\textsuperscript{248}

On the other hand, some courts have found that negligence is sufficient and thus, the defendant need not have engaged in fraudulent behaviour.\textsuperscript{249} As long as the corporation has suffered losses due to a director’s breach, it is sufficient to hold directors liable for deepening insolvency.\textsuperscript{250}

\textsuperscript{246} Kathy Bazoian Phelps, ‘Deepening Insolvency as A Cause of Action and as A Theory of Damages’ (Paper Presented at Association of Insolvency and Restructuring Advisors, 26\textsuperscript{th} Annual Bankruptcy and Restructuring Conference, San Diego, 9-12 June 2010) 3,
\textsuperscript{247} \textit{Seitz v Detweiler, Hershey & Association P C (In re CitX Corp)}, 448 F 3d 672 (3d Cir, 2006); see also \textit{OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp)}, 340 B R 510, 534 (Bankr D Del, 2006); \textit{Official Commission Of Unsecured Creditors v Foss (In re Felt Mfg Co Inc)}, 371 B.R. 589 (Bankr DNH 2007); Kathy Bazoian Phelps, ‘Deepening Insolvency as A Cause of Action and as A Theory of Damages’ (Paper Presented at Association of Insolvency and Restructuring Advisors, 26\textsuperscript{th} Annual Bankruptcy and Restructuring Conference, San Diego, 9-12 June 2010) 3.
\textsuperscript{248} Third Circuit is United States Court of Appeal, \textit{Seitz v Detweiler, Hershey & Association P C (In re CitX Corp)}, 448 F 3d 672 (3d Cir, 2006); see also \textit{OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp)}, 340 B R 510, 534 (Bankr D Del, 2006); \textit{Official Commission Of Unsecured Creditors v Foss (In re Felt Mfg Co Inc)}, 371 B.R. 589 (Bankr DNH 2007).
\textsuperscript{249} \textit{Smith v Arthur Andersen LLP}, 421 F 3d 989, 995 (9\textsuperscript{th} Cir, 2005).
\textsuperscript{250} Ibid.
Therefore, deepening insolvency is a cause of action which creditors can seek in order to claim against a director’s breach of duty not to incur debts while near insolvency. However, it is imperative to note that the elements to successfully establish this breach are unclear at best.  

1 Damages for Deepening Insolvency

The damages for deepening insolvency vary between each jurisdiction because the doctrine is not uniformly applied in the US. Lafferty’s case established that directors who contributed to the deepening of corporate insolvency could be liable for the total amount of the loss. There are little academic discussion on compensation except to say that directors are liable for the total amount of loss caused (as found in Lafferty) but nothing beyond that on the quantum of damages that may be awarded against liable directors.  

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254 Tabas v Greenleaf Ventures Inc (In re Flagship Healthcare Inc), 269 B R 721 (Bankr SD Fla 2001); Kathy Bazoian Phelps, ‘Deepening Insolvency as A Cause of Action and as A Theory of Damages’ (Paper Presented at Association of Insolvency and Restructuring
This next segment will compare each jurisdiction’s insolvent trading laws to assess their effectiveness protecting creditors’ interests.

E Which is Better, Australia, China or the US?

This segment is an analysis of the three jurisdictions’ insolvent trading laws or similar laws. This is to determine which jurisdiction provides better protects creditors’ interests. It will first compare Australia’s and China’s insolvent trading laws followed by a comparison of Australia’s and the US’s insolvent trading laws.

The comparison will conclude that Australia arguably has better insolvent trading laws because the laws are clearer and directors have an active duty to protect creditors’ interests.

Australia and China

(a) Similarities

Australia and China have provisions which hold directors liable if their actions lead the company into insolvency or bankruptcy. Directors in both jurisdictions are held responsible for damaging creditors’ interests.

(b) Differences

Firstly, Australia’s insolvent trading laws set out the elements for insolvent trading and also circumstances in which directors are considered to have participated in insolvent trading. Cases also supplement the Act by explaining the scope of circumstances that directors can be considered to have been involved in insolvent trading. For example, the Water Wheel case explains the situations in which a director is considered to have failed to prevent a company from incurring debt. This case supplements sections 588G(2) and 588G(3)(d).

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258 ASIC v Plymin [2003] VSC 123.
259 ASIC v Plymin [2003] VSC 123; Corporations Act 2001 (Cth) s 588G.
On the other hand, China has a dearth of academic or judicial discussion of the law in this area and there is no clear definition of insolvent trading or circumstances in which directors are considered to have participated in insolvent trading.²⁶⁰ This situation may cause creditors difficulty in suing directors, as has been discussed, the laws are limited in scope and unclear.²⁶¹

Thus, Australia has arguably better laws to protect and enable creditors to take legal action against directors if the former’s interests are harmed by the latter.

Secondly, it is submitted that Australia has a better compensation scheme for creditors than China. Under sections 588J, 588K and 588M of the Act, directors are liable to pay compensation equal to the amount of loss or damage suffered by all unsecured creditors whose debts were incurred in contravention of the duty to prevent insolvent trading during the company’s insolvency.²⁶² Arguably these laws ensure that the creditors in Australia are

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²⁶² Corporations Act 2001 (Cth) ss 588J, 588K and 588M.
fairly compensated and that their interests are not prejudiced when directors breach their duties.\textsuperscript{263}

The CBL provisions only state that offending director(s) will not be allowed to hold any directorial position for three years and there are no statutory creditors’ compensation that state that there is any compensation amount to be paid or compensation order to be made against the directors even if they are directly responsible for damaging creditors’ interests.\textsuperscript{264}

Thus, Australia provides better protection of creditors’ interests than China in respect of director’s breach of duty to prevent insolvent trading. Australia has more stringent laws to ensure that creditors’ interests are well protected as compared to China, including placing a positive duty on directors in respect of their conduct.

However, this discussion is not conclusive because China’s insolvent trading laws are still in their infancy and, as noted above, there is a dearth of academic commentary on the subject and few cases that rule on or discuss these laws.\textsuperscript{265} Thus, the conclusion that Australia has better creditor protection laws is mainly based on a limited reading of the provisions as

\textsuperscript{263} Ibid.
\textsuperscript{264} Please note that that directors in Australia can be disqualified from managing corporate under section 206C of \textit{Corporations Act 2001} (Cth) if they contravene s 588G; [Enterprise Bankruptcy Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 54, 1 June 2007, art 125; Minkang Gu, \textit{Understanding Chinese Company Law} (Hong Kong University Press, 2\textsuperscript{nd} ed, 2010) 326.
\textsuperscript{265} China has just include the directors’ duty to prevent insolvent trading laws in 2006, [Enterprise Bankruptcy Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 54, 1 June 2007, art 125; Kirkland and Ellis LLP, ‘China’s New Enterprise Bankruptcy Law’ (Research Paper, Kirkland and Ellis LLP, October 2006) 3.
enacted in CBL which over time (with more academic and judicial commentary on the subject) may be interpreted to have wider scope than they would presently seem to have.

The next segment will compare Australia’s and the US’s laws on insolvent trading. As noted above, China adopted the US’s laws on a director’s duty of good faith when a company is near insolvency, thus, US will be used as a substitute for China’s laws in keeping with the thesis’ aim of comparing the jurisdictions of Australia and China.

2 Australia and the US

In the absence of literature which compares these jurisdictions, the comparisons discussed here are tendered by the author based on her own considered reflections and analysis.

Australia enacts insolvent trading laws whereas the US applies deepening insolvency doctrine developed from case law. Although both enacted insolvent trading laws and the deepening insolvency doctrine protect creditors’ interests, Australia arguably has better protection as compared to the US because the directors have a positive duty to protect the creditors’ interests and the insolvent trading provisions are clearly and expressly spelt out.
(a) Similarities

Firstly, insolvent trading and deepening insolvency allow creditors to sue directors when they breach their fiduciary duties.\(^\text{266}\)

In Australia, creditors can sue directors if they suffered financial losses due to the directors’ breach of duty in preventing insolvent trading.\(^\text{267}\) However, as previously mentioned, in order for creditors to bring an action against directors, they are required to obtain a written consent from the company’s liquidator.\(^\text{268}\) Liquidators are given three months to give their written consent to the creditors, failing which, creditors can apply for leave of the court for the proceedings to begin at the end of three months.\(^\text{269}\) Even if the liquidator gives to the creditor a written statement why the proceedings should not be commenced within the stipulated three months, creditors can still apply for leave to the court for the proceedings to begin.\(^\text{270}\) If the court has granted leave, creditors may prosecute the proceedings without the liquidator’s consent.\(^\text{271}\)

Similar to insolvent trading laws in Australia, creditors have a standing to sue directors for their breach under the deepening insolvency theory.\(^\text{272}\) As been noted in Lafferty, the court held that deepening insolvency is a valid cause of

\begin{tabular}{l}
\(^{267}\) Corporations Act 2001 (Cth) s 588M.
\(^{268}\) Ibid s 588R.
\(^{269}\) Ibid s 588T(1).
\(^{270}\) Ibid s 588T.
\(^{271}\) Ibid s 588T.
\end{tabular}
action and creditors can bring a direct claim against directors for their alleged breach.\footnote{Official Committee of Unsecured Creditors v R F Lafferty and Co, 267 F 3d 340, 347-50 (3rd Circuit, 2001).}

Thus, both jurisdictions’ laws protect creditors by allowing them to claim against directors if they suffer any losses. Nevertheless, Australia shows that it has better creditors protection laws compared to the US because directors in Australia have a statutory duty to protect creditors’ interests in which there are clearer guides for creditors to sue directors if they suffer any injury caused by directors’ breach.

\textit{(b) Differences}

There is an express duty in Australia for directors to prevent insolvent trading whereas there are no similar provisions in the US.\footnote{Corporations Act 2001 (Cth) s 588G(2).} Directors in Australia are subjected to a fiduciary and statutory duty to not prejudice creditors’ interests when the company is insolvent or when the company is near insolvency.\footnote{Walker v Wimborne (1976) 137 CLR 1; Ring v Sutton (1979) 5 ACLR 546; Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) [2012] WASCA 157; Corporations Act 2001 (Cth) s 588G.} If directors reasonably suspect that the company is insolvent at the time debt was incurred, they must take positive steps to prevent any trading that may further increase the debt; failure to take positive steps could result in a breach and the directors could be personally liable for any losses caused to creditors.\footnote{ASIC v Plymin [2003] VSC 123; Williams v Scholz [2007] QSC 266.} A director’s duty is still considered breached if they do
not disclose or prevent any insolvent transaction in which other directors are involved.\textsuperscript{277}

On the other hand, the US does not have any statute that prevents insolvent trading; instead, the deepening insolvency theory as mentioned above, forms a common law safeguard against insolvent trading.\textsuperscript{278} In addition, directors in the US do not have a positive duty to protect creditors’ interests.\textsuperscript{279} The directors are only liable when they prolonged a company’s insolvency when a company should have filed for insolvency.\textsuperscript{280}

Further, Australia has better guidelines for creditors to bring an action against directors. This is because the insolvent trading laws are enshrined in statute and there are proper guidelines which creditors can follow in order to prove the elements of proving insolvent trading.\textsuperscript{281}

On the contrary, there are no statutes in the US which clearly list the elements of deepening insolvency. Deepening insolvency cases provide different

\textsuperscript{277} Williams v Scholz [2007] QSC 266; Re Mustang Marine Australia Services Pty Ltd [2014] NSWSC 1074.


\textsuperscript{281} \textit{Corporations Act 2001} (Cth) s 588M.
opinions on the elements.\textsuperscript{282} As stated above, there are cases which require fraud to prove deepening insolvency,\textsuperscript{283} while there are other cases which state that negligence is sufficient to prove that deepening insolvency.\textsuperscript{284} Therefore, this may cause confusion among creditors as to whether there is a chance of winning a legal action against directors.

Hence, creditors may not have full confidence in bringing an action against directors in the US, and thus, arguably Australia would appear to have better creditor protection laws compared to the US.\textsuperscript{285} The question may then be posed turn to that, if Australia has better creditor protection laws than the US, does this mean that because China’s laws are modelled on US laws, Australia thus has better insolvent trading laws than China?

It must be noted that the results from comparing the US and Australia be applied as a strict China and Australia comparison. This is because fundamental differences in China’s legal and political system may lead to laws being developed quite differently. However, to the extent that there might be some similar developments in the law in China to the US (if case


\textsuperscript{283} \textit{OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp)}, 340 B R 510 (Bankr D Del, 2006); \textit{Official Comm Of Unsecured Creditors v Foss (In re Felt Mfg. Co Inc)}, 371 B R 589 (Bankr DNH, 2007).


\textsuperscript{285} Kathy Bazoian Phelps, ‘Deepening Insolvency as A Cause of Action and as A Theory of Damages’ (Paper Presented at Association of Insolvency and Restructuring Advisors, 26th Annual Bankruptcy and Restructuring Conference, San Diego, 9-12 June 2010) 3
law in China takes a similar course to case law in the US on the issue of
deepening insolvency) then the above analysis might be useful, although
admittedly, it remains to be seen what course Chinese case law will take.

**F Conclusion of Directors’ Duties (Insolvent Trading)**

This Chapter discussed a director’s duty to prevent insolvent trading in the
jurisdictions of Australia, China and the US. In conclusion, Australia
arguably has better creditors’ protection in relation to insolvent trading.

This Chapter first compared Australia and China, and argued that Australia
has better insolvent trading laws. Australia has a compensation plan whereas
China does not.²⁸⁶ This means creditors in Australia are reasonably certain
they will be reimbursed if they are successful in court whereas in China,
successful cases only result in directors being disqualified from their
directorial positions.²⁸⁷

Both Australia and China have statutory provisions on insolvent trading laws,
but Australia’s laws are clearer compared to China as discussed above.²⁸⁸ It

²⁸⁶ **Corporations Act 2001** (Cth) ss 588J, 588K and 588M; [Enterprise Bankruptcy Law of
the People’s Republic of China] (People’s Republic of China) National People’s Congress,
Order No 54, 1 June 2007, art 125.
²⁸⁷ [Enterprise Bankruptcy Law of the People’s Republic of China] (People’s Republic of
China) National People’s Congress, Order No 54, 1 June 2007, art 125.
²⁸⁸ **Corporations Act 2001** (Cth) s 588G; **Williams v Scholz** [2007] QSC 266; **ASIC v Plymin**
[2003] VSC 123; John J Rapisardi and Binghao Zhao, ‘A Legal Analysis and Practical
Application of the PRC Enterprise Bankruptcy Law’ (2010) 11(1) **Business Law
International** 49, 53; Roman Tomasic, ‘The Conceptual Structure of China’s New Corporate
Bankruptcy Law’ in **China’s New Enterprise Bankruptcy Law** (Ashgate, 2010) 15; Steven J
Arsenault, ‘The Westernization of Chinese Bankruptcy: An Examination of China’s New
Corporate Bankruptcy law through the Lens of UNICITRAL Legislative Guide to
is important to note that this evaluation is based on the CBL provisions because there are only a few cases concerning directors’ duty to prevent insolvent trading, perhaps due to the fact that the right to sue directors might be seen as undermining the state’s authority since SOEs still tightly controls and influences China’s company’s decisions.\textsuperscript{289}

This Chapter also compared Australia’s and the US’s insolvent trading laws because as noted above, Chinese directors’ duty to be honest when the company is near insolvency is modelled on the US’s directors’ duty during deepening insolvency.\textsuperscript{290}

Unlike in the US, directors in Australia have an active duty to prevent insolvent trading in order to ensure creditors’ interests are protected.\textsuperscript{291} Australia also has better guidelines for creditors when to bring an action against directors compared to the US.\textsuperscript{292} Thus, Australia has better insolvent trading laws to protect creditors’ interests than US, and so even if China were to develop its CBL along US lines, having modelled its laws on the US, Australia’s insolvent trading laws would still offer better protection to creditor’s than China’s.

Based on the analysis of Australia and China, the author suggests that China should adopt a similar model to Australia’s compensation plan. This may

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{289} This was discussed above in Chapter III, page 50, and footnote 218.
\item \textsuperscript{291} \textit{Corporations Act 2001} (Cth) s 588G.
\item \textsuperscript{292} Ibid s 588M.
\end{itemize}
\end{footnotesize}
help China to take a step forward to protect creditors because courts are able to order directors to compensate the creditors instead of only being able to disqualify directors from their directorial position.

The next Chapter, Piercing the Corporate Veil will compare the circumstances in which courts can pierce the corporate veil in Australia and China.
This Chapter will discuss and compare China’s and Australia’s veil-piercing laws to analyse which jurisdiction provides a better protection for creditors’ interests, concluding that overall, that Australia accords a better creditors’ protection than China.

A company is a legal person separate from its controllers, namely, directors and majority shareholders. This means that although a company can be sued, the controllers will not usually be liable for the company’s debts. A creditor can only take action against the company and not the controllers unless the court pierces the corporate veil. This will only occur in circumstances where the behaviour of the company’s controllers is seen as abusing the corporate veil.

This Chapter first explains the basis for veil piercing in Australia, covering the grounds of fraud and agency before venturing into veil piercing in group companies. The discussion then shifts to China, analysing Articles 20 and 64 of the revised CCL, which form China’s veil piercing doctrine. The final

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segment of this Chapter wraps up with a comparison of both jurisdictions’ veil piercing doctrines from the perspective of creditors’ interests protection.

**B Piercing the Corporate Veil in Australia**

The discussion on the veil piercing doctrine begins with three fundamental common law factors which allow a court to pierce the corporate veil and hold the controllers liable for the company’s debts.

Australia adopted the UK veil piercing laws and has developed them since one of the first Australian piercing cases in 1911. The significant cases of *Lipman v Jones* and *Adam v Cape* established three different factors which allow a court to pierce the corporate veil. The three factors are fraud, agency and group companies (single economic unit). The circumstances that allow courts to pierce the corporate veil of a group of companies are insolvent trading, agency and tort liabilities. Tort liabilities will not be discussed as this thesis is aimed at analysing creditors’ interests in the context of creditors’ contractual rights against the company rather than their general legal rights.

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297 *Electric Light and Power Supply Corporation Ltd v Cornack* (1911) 11 SR (NSW) 350; The history of doctrine of piercing the corporate veil from the UK has been discussed in Chapter I – Introduction of this thesis, page 23.
298 *Jones v Lipman* [1962] All ER 442; *Adams v Cape plc* [1990] 1 Ch 433.
299 *Adams v Cape plc* [1990] 1 Ch 433.
It is important to note that Australia also has statutory veil piercing laws. These are directors’ liabilities for insolvent trading (which was discussed in Chapter II – Directors’ Duties (Insolvent Trading)), unpaid tax, personal liabilities of directors of trustee corporations and a holding company’s liabilities for its subsidiary’s debts. The segment in this Chapter regarding statutory veil piercing will only discuss a holding company’s liabilities for a subsidiary’s debts as because the focus of this Chapter is on the common law factors.

Fraud is one of the three factors in which courts pierce the corporate veil.

1 Fraud

This segment discusses fraud as one of the factors which will trigger veil-piercing doctrine. Fraud occurs when directors or shareholders use a company to evade legal obligations, or misrepresent its performance or financial obligations or its financial structure. Courts are not hesitant to

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301 Corporations Act 2001 (Cth) s 588G.
302 Ibid ss 588FE and 588FF.
303 Ibid s 197.
304 Ibid s 588V.
pierce the corporate veil when a company is incorporated to defraud creditors or to circumvent laws.\textsuperscript{307}

Plaintiffs have to show that a company is a sham or mere façade in order to pierce the corporate veil.\textsuperscript{308} There is a distinction between sham and mere façade and the next segment discusses both these limbs of fraud.

A company is a sham when it is incorporated to disguise the true intention of its operators or to avoid any legal obligations.\textsuperscript{309} \textit{Gilford Motor Company Ltd v Horne} is an example in which the corporate veil was pierced because the company was a sham used for fraud.\textsuperscript{310}

Horne was an ex-employee of Gilford Motor Company and the employment contract provided that he could not solicit customers of the company during his employment or after the termination of his appointment. In order to defeat this, he incorporated a limited company in his wife’s name and solicited his former employee’s customers on the company’s behalf. Gilford Motor Company brought an action seeking to restrain Horne and the company he formed from soliciting their customers. The Court of Appeal held that the main purpose of the new company’s incorporation was to perpetrate fraud.

\begin{flushleft}
\textsuperscript{307} \textit{Re Darby} [1911] 1 KB 95; \textit{Jones v Lipman} [1962] All ER 442; \textit{Gilford Motor Co Ltd v Horne} [1933] Ch 935; Philip Lipton, Abe Herzberg and Michelle Welsh, \textit{Understanding Company Law} (Lawbook Co, 17th ed, 2014) 44.

\textsuperscript{308} \textit{Donnelly v Eldesten} (1994) 13 ACSR 196, 256.

\textsuperscript{309} \textit{Sharment Pty Ltd v Official Trustee in Bankruptcy} (1998) 19 FCR 449, 456; \textit{Gilford Motor Co Ltd v Horne} [1933] Ch 935.

\textsuperscript{310} \textit{Gilford Motor Co Ltd v Horne} [1933] Ch 935; see also \textit{Jones v Lipman} [1962] 1 WLR 832.
\end{flushleft}
Thus, the company was regarded as a sham to mask his wrongdoings. An injunction was granted against Horne and the new company.\textsuperscript{311}

Fraud also occurs when a company is a mere façade concealing true facts.\textsuperscript{312} In \textit{Jones v Lipman}, ‘mere façade concealing true fact’ refers to a company which is formed to avoid pre-existing obligations.\textsuperscript{313} Australian courts have followed \textit{Jones v Lipman} and \textit{Gilford Motor Company Ltd v Horne}.\textsuperscript{314} Jenkinson J in \textit{Dennis Willcox} stated that:

The separate legal personality of a company is to be disregarded only if the court can see that there is, in fact or in law, a partnership between companies in a group or that there is a mere sham or façade in which that company is playing a role, or that the creation or use of the company was designed to enable a legal or fiduciary obligation to be evaded or a fraud to be perpetrated.\textsuperscript{315}

This statement shows that Australian courts are willing to pierce the corporate veil when a company is a sham or mere façade, which affirms the decisions in \textit{Jones v Lipman} and \textit{Gilford Motor Company Ltd v Horne}.\textsuperscript{316}

\begin{itemize}
\item \textsuperscript{311} \textit{Gilford Motor Co Ltd v Horne} [1933] Ch 935.
\item \textsuperscript{312} \textit{Adams v Cape plc} [1990] 1 Ch 433.
\item \textsuperscript{313} \textit{Jones v Lipman} [1962] 1 WLR 832.
\item \textsuperscript{315} \textit{Dennis Willcox Pty Ltd v Federal Commissioner of Taxation} (1988) 79 ALR 267, 272.
\item \textsuperscript{316} \textit{Jones v Lipman} [1962] 1 WLR 832; \textit{Gilford Motor Company Ltd v Horn} [1933] Ch 935; \textit{Dennis Willcox Pty Ltd v Federal Commissioner of Taxation} (1988) 79 ALR 267;
\end{itemize}
A recent example is Re Neo. In that case, the Australian Immigration Review Tribunal reviewed a decision to refuse a company’s sponsorship of visa for an overseas applicant. The company was formed on the same day that the application was lodged, and never carried out any business. The Tribunal ruled that, ‘the company was merely a vehicle used to circumvent Australian migration law. It was only a façade, its true purpose being to allow the applicants to remain in the country’.  

It is well established that the courts will not allow the corporate form to be used for the purposes of fraud or as a device to evade a contractual or other legal obligation, a principle which is referred to hereafter as the ‘fraud exception’ to the Salomon’s principle. Thus, fraud is a valid avenue which creditors can pierce the corporate veil if a company is found to be a sham or mere façade.

The next segment will discuss Agency, the second factor which allows Australian courts to pierce the corporate veil.

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317 Re Neo (Unreported, Immigration Review Tribunal, Metledge M, 30 July 1997)
318 Ibid 7.
320 Ibid
2 Agency

Agency states that a shareholder or a parent company has such a strong degree of control that the company is deemed to be an agent of the shareholder or the parent company.\(^{321}\) Therefore, the acts of the company are deemed to be acts of the shareholder or the parent company.\(^{322}\) If a subsidiary or a company is found to be acting as an agent for a parent company or a shareholder, the courts will pierce the corporate veil.\(^{323}\) There are two types of agency, express and implied.

An express agency agreement is where one legal entity acts under the express authority of another legal entity.\(^{324}\) Veil piercing occurs because the law of agency acknowledges that the principal (shareholder or parent company) is bound, by, and responsible for the acts of its agent (company or subsidiary).\(^{325}\) Therefore, the veil-piercing doctrine deems the principal responsible for the acts of the agent.

An implied agency relationship arises where the principal places the agent in circumstances where it is understood that the agent represents and acts for the

\(^{321}\) *International Harvester Co of Australia Pty Ltd v Carrigan’s Hazeldene Pastoral Co* (1958) 100 CLR 644, 652.

\(^{322}\) Ibid.


\(^{324}\) Legal entity can be a natural person or an artificial body such as a company that has legal standing in the eyes of law, *Trustees of the Roman Catholic Church for the Archdiocese of Sydney v Ellis* (2007) 70 NSWLR 565.

However, an agency relationship is not always present between parent and subsidiary companies or between a shareholder and a company. Atkinson J in *Smith, Stone and Knight Ltd v Birmingham* stated that there are six requirements that must be established before an implied agency relationship is established. The six requirements that were stated by his Honour are:

1) Were the profits treated as the profits of the parent?
2) Were the persons conducting the business appointed by the parent?
3) Was the parent the head and the brain of the trading venture?
4) Did the parent govern the venture; decide what should be done and what capital should be embarked on the venture?
5) Did the parent make the profits by its skill and direction?
6) Was the parent in effectual and constant control?

The decision and the application of the six factors in *Smith, Stone and Knight Ltd v Birmingham*, was followed in the Australian case of *Spreag v Paerson Pty Ltd*, where the court held a parent company liable for the subsidiary’s misleading and deceptive statements and breaches of implied terms of a contract.

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326 *Pole v Leask* [1861-73] All ER Rep 535, 541.
327 *Smith, Stone and Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116, 121.
328 Ibid.
329 Ibid.
331 Lipton, above n 3, 49.
The Spreags were builders who purchased a brickmaker from Paeson Pty Ltd (‘Paeson’).\textsuperscript{332} The purchase was conditional on Paeson sending staffs to demonstrate use of the machinery. Once delivered, the demonstration staffs were unable to adjust the machinery to produce marketable bricks at the negotiated rate of production, roughly 500 to 600 bricks per hour. The Spreags sought damages from inter alia, Componere Systems Pty Ltd (‘Componere’) which had banked Spreags’ cheque for the purchase of the brickmaker.\textsuperscript{333}

The court found that Paeson did not have any bank account, assets or premises, account books or profit and loss statements. Componere made payments on Paeson’s behalf, including wages. Moneys received by Paeson, or on its behalf were paid to Componere. The business card of Paeson’s salesperson, Foster with whom the Spreags dealt suggested that he was a representative of Componere. After considering the six factors in \textit{Smith, Stone and Knight Ltd v Birmingham},\textsuperscript{334} Sheppard J held that Componere should be seen as the principal of this business transaction and the subsidiary, Paeson was carrying on business for Componere as an agent.

Although the law in Australia acknowledges that agency is a valid ground to pierce the corporate veil, there are some cases that require more evidence than a mere fact that a company is under control of a parent company.\textsuperscript{335} This

\textsuperscript{332} \textit{Spraeg v Paerson Pty Ltd} (1990) 94 ALR 679.
\textsuperscript{333} \textit{Spraeg v Paerson Pty Ltd} (1990) 94 ALR 679; Philip Lipton, Abe Herzberg and Michelle Welsh, \textit{Understanding Company Law} (Lawbook Co, 17\textsuperscript{th} ed, 2014) 49.
\textsuperscript{334} \textit{Smith, Stone and Knight Ltd v Birmingham Corporation} [1939] 4 All ER 116, 121.
\textsuperscript{335} ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570; \textit{Pioneer Concrete Services Ltd v Yelnah Pty Ltd} (1986) 5 NSWLR 254 (SCNSW, Young J); Philip
means that Australia sets a higher threshold than the UK to prove an implied agency relationship.\footnote{Pioneer v Yelnah, the court noted that it is not sufficient to create an implied agency between a parent and subsidiary company even though there is an overwhelming control of the former over the latter.} In \textit{Pioneer v Yelnah}, the court noted that it is not sufficient to create an implied agency between a parent and subsidiary company even though there is an overwhelming control of the former over the latter.\footnote{Besanko J in \textit{Bird Cameron} stated that the most important factor to determine agency is the first question identified by Atkinson J in \textit{Smith, Stone and Knight Ltd v Birmingham}. His Honour relied on that question and determined whether the directors in the company owned the profits made by the company. His Honour stated:}

\begin{quote}
The first matter identified by Atkinson J in \textit{Smith, Stone and Knight v Birmingham Corporation} [1939] 4 All ER 116 \{that is where the profits of the business are treated as the profits of the parent company\} is an important, sometimes very important indicator of whether or not there is an agency relationship\footnote{ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570, 112.}…However, too much emphasis on the other five [criteria] related to control and control of itself cannot be a decisive
\end{quote}

\footnote{Jason Harris, Anil Hargovan and Michael Adams, \textit{Australian Corporate Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2011) 188.}


\footnote{ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570.}

\footnote{ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570.}

\footnote{Smith, Stone and Knight Ltd v Birmingham Corporation [1939] 4 All ER 116, 121; Jason Harris, Anil Hargovan and Michael Adams, \textit{Australian Corporate Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2011) 188.}
indicator of agency. If it were otherwise there would often be an agency between a parent company and its subsidiary or a sole shareholder and his company.\textsuperscript{341}

This recent case reaffirms the importance of ownership of profits in identifying an agency relationship between members of a company or between a subsidiary and a parent company.\textsuperscript{342} This case is also important in identifying the significant element in determining an implied agency relationship, which is whether the profits of the subsidiary company are treated as profits of the parent company.\textsuperscript{343} The requirements to prove implied agency between a shareholder and the company is the same as above.\textsuperscript{344} Creditors have to prove that shareholders have an excessive control over the company as well as treating the company’s profit as their own.\textsuperscript{345}

Summing up, agency is a valid ground for piercing the corporate veil in Australia.\textsuperscript{346} There are two types of agency, namely express and implied agency. The veil is pierced when a shareholder or a parent company has excessive control over the company or its subsidiary and owns its profits.\textsuperscript{347}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{341} Ibid 224.
\item \textsuperscript{342} Jason Harris, Anil Hargovan and Michael Adams, \textit{Australian Corporate Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2011) 188.
\item \textsuperscript{343} ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570, 112.
\item \textsuperscript{344} Harris, above n 336, 13.
\item \textsuperscript{345} Ibid.
\item \textsuperscript{346} ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570, 112; Philip Lipton, Abe Herzberg and Michelle Welsh, \textit{Understanding Company Law} (Lawbook Co, 17\textsuperscript{th} ed, 2014) 48.
\item \textsuperscript{347} Lipton, above n 3, 48.
\end{itemize}
\end{footnotesize}
The third factor is when a group of companies are treated as a single economic unit. The next segment discusses instances when a court can pierce the veil of group companies.

3 Piercing the Veil of Group Companies (Single Economic Unit)

This segment will discuss the factors which will allow the courts to treat a group of companies as a single unit or a ‘single economic unit’.

Companies often operate as a group in a commercial sphere and are identified as corporate groups or group companies. Although they operate as group companies, Salomon’s principle allows each of them to be identified as separate legal entities. Roskill LJ in The Albarzero has also noted this principle. His Honour stated:

Each company in a group of companies... is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company in a group cannot be exercised by another company in that group even though the ultimate benefit of the exercise of those rights would inure beneficially to those person or body corporate irrespective of the person or body in whom those rights were vested in law. It is perhaps permissible

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under modern commercial conditions to regret existence of those principles. But it is impossible to deny, ignore or disobey them.\textsuperscript{351}

In other words, benefits and rights of a company are distinct from each other and this has to be acknowledged by each of the companies, directors, shareholders, employees and creditors.\textsuperscript{352} However, a court will pierce the corporate veil on the ground of ‘group enterprises’ where there is a sufficient degree of common ownership and common enterprise.\textsuperscript{353}

To this end, creditors are entitled to look at the resources of companies operating as a group if the court pierces the corporate veil of each of the group companies.\textsuperscript{354} The next segment will discuss the circumstances which allow courts to pierce the corporate veil of group companies.

\textit{(a) Insolvent Trading}

One of the factors which allow a court to pierce the corporate veil of group companies is when subsidiaries are involved in insolvent trading.\textsuperscript{355} The discussion will only focus on a holding company liability when the subsidiary incurs debts during insolvency.

\textsuperscript{351} Ibid.
\textsuperscript{352} Jason Harris, Anil Hargovan and Michael Adams, \textit{Australian Corporate Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2011) 182; see also \textit{Walker v Wimborne} (1976) 137 CLR 1 at 6 per Mason J; \textit{Adams v Cape Industries pls} [1990] 1 Ch 433.
\textsuperscript{353} Ramsay, above n 73, 263.
\textsuperscript{354} Harris, above n 342, 182.
\textsuperscript{355} \textit{Corporations Act 2001} (Cth) s 588V.
Section 599V of the Act states that a holding company is liable if it fails to prevent one of its subsidiaries from incurring debt when there are reasonable grounds to suspect that the subsidiary is near insolvency.\textsuperscript{356} A subsidiary incurs debt when a company ‘acts to expose itself contractually to an obligation to make a future payment of a sum of money as a debt’.\textsuperscript{357} It also incurs a debt when it exposes itself to an obligation to pay taxes, for example, sales tax.\textsuperscript{358}

Section 588W of the Act allows a liquidator to recover debts on behalf of the creditors when a holding company contravenes section 588V and becomes insolvent.\textsuperscript{359} Section 544W of the Act also states that the debts have to be either wholly or partly unsecured in order to recover from the company.\textsuperscript{360} However, sections 588R and 588T of the Act provide that only creditors can commence proceedings directly against directors for insolvent trading.\textsuperscript{361} Thus, the liquidator will commence proceedings against holding companies on behalf of all the creditors for the losses and damages suffered by them.\textsuperscript{362}

\textsuperscript{356} Ibid.

\textsuperscript{357} \textit{Hawkins v Bank of China} (1992) 26 NSWLR 562 at 572 per Gleeson CJ.

\textsuperscript{358} Sales tax is tax imposed by the government at the point of sale on retail goods and services, \textit{Powell v Fryer} [2001] SASC 59.

\textsuperscript{359} \textit{Corporations Act 2001} (Cth) s 588W.

\textsuperscript{360} Ibid.

\textsuperscript{361} Ibid ss 588R and 588T.

\textsuperscript{362} Murphy, above n 328, 256.
(b) Agency

The second factor which allows the court to pierce the corporate veil of group companies is agency. This segment will not analyse and discuss agency because it has been discussed above and the circumstances in which creditors can sue the holding company are the same. It is sufficient to note that in Australia, agency is one factor courts may utilize to pierce the corporate veil of group companies.

Agency, as mentioned above, occurs when a holding company has effective control over the subsidiary and the subsidiary’s actions are alleged to be the actions of the holding company. In these circumstances, courts may pierce the corporate veil of group companies and allow creditors to claim damages or compensation from the holding company. Also mentioned above, in Bird Cameron, Besanko J noted that the holding company must have excessive control over its subsidiary and own its profits in order to prove an implied agency.

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363 Smith, Stone and Knight Ltd v Birmingham Corporation [1939] 4 All ER 116; Spraeg v Paerson Pty Ltd (1990) 94 ALR 679; ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570; Pioneer Concrete Services Ltd v Yelnah Pty Ltd (1986) 5 NSWLR 254 (SCNSW, Young J); Philip Lipton, Abe Herzberg and Michelle Welsh, Understanding Company Law (Lawbook Co, 17th ed, 2014) 49.

364 International Harvester Co of Australia Pty Ltd v Carrigan’s Hazeldene Pastoral Co (1958) 100 CLR 644, 652.


366 ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg) (2005) 91 SASR 570, 224.
In sum, there are three factors, which will pierce the corporate veil in Australia – fraud, agency and group companies.\textsuperscript{367} These principles were inherited from the UK and allow creditors to petition a court to pierce the corporate veil to recover debts.\textsuperscript{368} This avenue of recovery is also available in respect of group companies and creditors can sue holding companies for their subsidiaries’ debts.\textsuperscript{369}

The next part will discuss China’s veil piercing laws.

\textbf{C Piercing the Corporate Veil in China}

Chinese Company Law 1994 was China’s first company law legislation and only focused on company registration, restructuring states enterprises and introducing joint stock companies to attract foreign investments and the concepts of limited liability and separate legal entity status.\textsuperscript{370} There was no veil-piercing doctrine and as a result, there were many corporate veil abuses. An example of this is where the shareholder formed an undercapitalised


\textsuperscript{368} Philip Lipton, Abe Herzberg and Michelle Welsh, \textit{Understanding Company Law} (Lawbook Co, 17\textsuperscript{th} ed, 2014) 46; Colin Anderson et al, \textit{Corporations Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2009) 62; Jason Harris, Anil Hargovan and Michael Adams, \textit{Australian Corporate Law} (LexisNexis Butterworths, 3\textsuperscript{rd} ed, 2011) 182.


company to defraud creditors.\textsuperscript{371} Although some courts pierce the corporate veil despite a statutory absence of veil-piercing doctrine, not all courts do so.\textsuperscript{372} Chinese lawmakers acknowledged the existence of corporate veil abuse and resolved to draft a revised CCL.\textsuperscript{373} In 2006, a revised CCL was enacted and it introduced veil-piercing doctrine to the corporate world in China. The Law Commission of China also states that in circumstances where there is a need to protect creditors’ interests and in the interests of justice, courts can implement veil piercing doctrine.\textsuperscript{374}

The revised CCL states that shareholders are held accountable if they abuse the principles of limited liability and separate legal entity status.\textsuperscript{375} Shareholders are jointly and severally liable if they abuse these principles to


\textsuperscript{372} Supreme People’s Court has the authority to decide cases in the interest of justice. They also have the authority to fill out the gaps where the legislation is incomplete and have very great importance in this circumstance, William C Jones, \textit{Basic Principles of Civil Law in China} (M E Sharpe Inc, 1991) 25.

\textsuperscript{373} Chinese lawmakers have also been under pressure to include veil piercing laws into the Chinese Company Law. This is because there was a need to keep up with the rapid economic development and globalisation in China and also to attract foreign investment, Shuangge Wen, ‘The Ideals and Reality of A Legal Transplant – The Veil-Piercing Doctrine in China’ (2014) 50(2) \textit{Stanford Journal of International Law} 219, 330; Chao Xi, ‘Piercing the Corporate Veil in China: How Did We Get There?’ (2011) 5 \textit{Journal of Business Law} 413, 418; [Rosin Factory of Wuzhou v Huajin Materials and Vill. Enter Commision of Jiangcheng, Guangdong – Undercapitalization case] [1991] [Gazette of the Supreme People’s Republic of China].

\textsuperscript{374} Kangtai Cao, ‘An Explanation to the Amended Draft of Company Law of People’s Republic of China’ (Speech delivered at the Fourteenth Session at the Tenth National People’s Congress, 25 February 2005).


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avoid debt-payment. These revised laws were intended to protect the company and creditors.

The next segment will discuss the veil piercing provisions, specifically, Articles 64 and 20 and other circumstances which academics suggest may enable the courts to pierce the corporate veil.

1 Article 64 – Commingling of Assets

Article 64 of CCL deals with a sole shareholder commingling his or personal assets with the company’s assets.

One person companies can be incorporated in China, in which there is only one shareholder (in which he or she solely funds the company). However, the lawmakers were concerned that a sole shareholder may take advantage of the company’s assets or profits for personal use, thereby defrauding creditors. In order to prevent such abuse, CCL provided veil-piercing

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379 [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 27 October 2005, art 58; The purpose to allow the incorporation of one-man companies is to achieve economic development and to increase employment. Allowing incorporation of one-man companies was seen as an important means of easing the unemployment caused by large-scale retrenchment of SOEs in 2005. A sole shareholder companies can have 2 or more directors but he or she must have solely funded the company, Jianlin Chen, ‘Clash of Corporate Personality Theories: A Comparative Study of One-Member Companies in Singapore and China’ (2008) 38 Hong Kong Law Journal 425, 434.
380 Pinsent Masons, above n 376, 2.
provisions specifically catered to tackle sole shareholder limited liability companies.\textsuperscript{381}

Article 64 of the CCL provides that:

The shareholder of a one-person limited liability company who is unable to prove that the company’s assets are independent of the shareholder’s personal assets shall bear jointly liability for the company’s debt.\textsuperscript{382}

The sole shareholder has to prepare and produce relevant documentation in order to prove that the company and their personal assets are independent.\textsuperscript{383}

In particular, he or she has to produce an annual financial accounting report for auditing and a set of records and documents evidencing the company’s trading transactions over the relevant reporting period.\textsuperscript{384} If there is any ambiguity or suspicion that there is commingling of assets, the shareholder may be sued under article 64.\textsuperscript{385}

The sole shareholder bears the burden of proof if he or she is sued to show that the company is an independent entity where its assets are separately owned and managed.\textsuperscript{386} He or she has to produce other documents besides the


\textsuperscript{383} Ibid art 63.


\textsuperscript{385} Wu, above n 377, 333.

\textsuperscript{386} [Deng v Jiang and Other Shareholders] [2010] 1 [Gazette of the Shanghai Intermediate People’s Ct]; JiangYu Wang, Company Law in China: Regulation of Business Organizations
annual financial accounting report and trading records to prove that there was no commingling of assets.  

For example, when a sole shareholder sets up a company and operates their business from their personal home, they have to be able to demonstrate that the house is not acquired with funds related to the company’s assets. They need to produce documents such as the certificate of title, house contract or bank loan in addition to a set of the company’s financial reports and trading records to prove that the house is separate from the company. If they are unable to produce them, they are personally liable to compensate the creditors. This is because they are deemed have used the funds from company’s assets to buy their house, which decreases the funds that are available to pay the creditors, thereby injuring creditors’ interests.

In conclusion, if creditors find that a sole shareholder has commingled his company’s assets and their personal assets, they can sue the shareholder under article 64 of CCL.

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The next segment discusses the second statutory avenue which creditors can seek if a shareholder abuses the limited liability and separate legal entity status principles.

2 Article 20 – Avoiding Payment

Article 20 of the CCL provides that the shareholders of a company must not abuse the company’s legal person status or shareholders’ limited liability (by avoiding payment to creditors) and this extends to all companies in China.\(^{389}\)

If shareholders abuse these principles and damage creditors’ interests, they are personally liable for damages, a concept as discussed below.\(^{390}\)

There are three elements that courts must consider in order to pierce the corporate veil under Article 20 of the CCL.\(^{391}\) The three elements are: i) there must be an abuse; ii) creditors’ interests are seriously damaged due to the abuse, and iii) there must be a relationship between the shareholders’ actions and the creditors’ loss.\(^{392}\)

Firstly, there has to be evidence that there is an abuse of the company’s separate legal entity status and limited liability protection.\(^{393}\) ‘Abuse’ in this


\(^{390}\) Ibid.


\(^{392}\) Wang, above n 41, 83.

\(^{393}\) Ibid.
context refers to avoiding payment of company’s debts. 394 This occurs when a shareholder of a heavily indebted company incorporates another company using funds from the former company and transferring over its valuable assets to form the new company. 395 This is detrimental to the first company’s creditors because in the event of insolvency, there are less assets to pay off creditors. The law will consider the new company a sham because the above-mentioned tactic is an abuse of the corporate veil to avoid payment of the former company’s debts. 396

The second element is that the interests of the creditors must be ‘seriously damaged’ under Article 20. However, there is no statutory definition of ‘seriously damaged’, in the CCL. 397 Yousu Zhou proposes that the courts should consider three limbs when determining the term ‘seriously damaged’ when applying the veil-piercing doctrine. 398 The three limbs are: the actual damage to the creditors, the ability of a company to pay the injured creditors and the intention of the shareholders. 399

The first limb assesses actual damage to creditors. This is determined by assessing the amount of debt that the company is not able to pay to the

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395 Wang, above n 41, 81.
396 Ibid.
398 Zhou, above n 195, 105.
399 Ibid.
creditors.\textsuperscript{400} The larger the amount of actual damage, the more serious the damage caused to the creditors.\textsuperscript{401}

The second limb measures the ability of a company to pay the injured creditors. The courts will evaluate this ability by reviewing the company’s assets.\textsuperscript{402} If the assets decreased dramatically because the shareholders used the company’s assets or funds to create another company, the courts may proclaim that the creditors’ interests are seriously damaged.\textsuperscript{403}

The final limb is that shareholders must have the intention to injure the creditors when committing any activities that are alleged to have abused the corporate veil.\textsuperscript{404} Zhou proposed a test similar to Australia’s ‘reasonably foreseeable’ test.\textsuperscript{405} If it is reasonably foreseeable that the shareholders’ actions would injure creditors’ interests, yet they still continue with their actions, the shareholders’ intention to abuse the corporate veil will be deemed to be established.\textsuperscript{406}

Thus, if these three limbs are satisfied, the second element will be established and shareholders will be accountable to creditors under Article 20.


\textsuperscript{401} Ibid.

\textsuperscript{402} Zhou, above n 195, 105.

\textsuperscript{403} Ibid.


\textsuperscript{405} Zhou, above n 201, 105.


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The last element that the court has to consider when piercing the corporate veil under Article 20 is that there must be a relationship between shareholders’ actions and creditors’ loss.\textsuperscript{407} There must be evidence of the shareholders causing the creditor’s loss and damage.\textsuperscript{408} For example, if the shareholders of a heavily indebted company have not used its assets or funds from the assets to set up another company, the ability of the heavily indebted company to repay the creditors would not have decreased.\textsuperscript{409}

Thus, the court will be more willing or prepared to pierce the corporate veil if the above three factors are present.\textsuperscript{410} If the court finds that shareholders have transferred assets from an indebted company to a new company, creditors from the former company may ‘follow’ the assets to the latter company, and claim their debt from it.\textsuperscript{411}

Besides the corporate abuses listed above, Articles 64 and 20, there are other types of abuse. These abuses include avoiding contractual or statutory obligation and undercapitalization and these will now be examined.\textsuperscript{412}

\begin{footnotesize}
\begin{itemize}
\item[407] Wang, above n 41, 82.
\item[408] Zhou, above n 195, 105.
\item[410] Wang, above n 41, 81.
\item[411] Chen, above n 387, 442.
\end{itemize}
\end{footnotesize}
3 Other Types of Abuses

(a) Avoiding Contractual or Statutory Obligation

The CCL does not specify any other circumstances that are considered to be an abuse of the corporate veil, but the SPC has paid close attention to other types of abuse such as fraud.413

Some academics have suggested that shareholders who use the company to avoid contractual or statutory obligations is another type of abuse which courts may consider when piercing the corporate veil.414 This is similar to Australia’s fraud principle mentioned above.

Some shareholders avoid statutory obligations such as paying taxes by incorporating a company.415 A shareholder who is required to refrain from non-competitive activities from his or her former employment (due to a non-
competition agreement) is allegedly in breach of their contractual obligations if they set up a company to carry out their work.\textsuperscript{416}

The next type of corporate abuse by shareholders is undercapitalisation.

\textit{(b) Undercapitalisation}

There are no provisions in CCL addressing whether undercapitalisation is another form of abuse that may trigger the veil-piercing doctrine. However, academics such as Jinwei Feng and Xianchu Zhang state that courts may be willing to pierce the corporate veil based on this factor to protect creditors’ interests.\textsuperscript{417}

Both academics explain that as Chinese courts have in the past pierced the corporate veil despite an absence of statutory provisions on veil piercing, the courts may pierce the veil if there has been corporate abuse via undercapitalisation.\textsuperscript{418}

\textsuperscript{416} Donald C Clarke, ‘Corporate Governance in China: An Overview’ (2003) 14 China Economic Review 494, 502; Minkang Gu, Understanding Chinese Company Law (Hong Kong University Press, 2\textsuperscript{nd} ed, 2010) 98.


This is seen in a 1991 case, *Rosin Factory of Wuzhou v Huajin* where the court pierced the corporate veil.\(^419\) In this case, the court found that the Rosin company was only a shell company with no capital and no ability to perform any contracts, thus did not meet the conditions of a ‘limited liability company’. The sole shareholder was held liable for undercapitalisation.\(^420\)

In 1994, the SPC also pierced the corporate veil for undercapitalisation.\(^421\) An agriculture machine, a metal plate plant company and a municipal old age commission company established a biotech company. According to the articles of association, each party was to contribute RMB 100,000 in registered capital. However, the old age commission failed to pay its registered capital, therefore the actual paid in capital of the company was only RMB 200,000. The company then borrowed RMB 200,000 from a bank with a local technology company as their guarantor. When the company failed to pay back the loan, the guarantor paid the amount owed to the bank.

The guarantor then sought repayment from the company but the company was only able to repay RMB 6,000. The guarantor then sued all three investors in the company, claiming that they should be responsible for the


debts of the company. The defendant company argued that it was properly established and licensed, therefore, should be protected by the corporate veil.

The court decided that even though the company was issued a business license, it did not qualify as a legal person because it did not meet the required minimum capital of a limited liability company. Hence, the court pierced the corporate veil and held all investors jointly and severally liable. The guarantor was able to recover the outstanding amount owed from the three investors.422

Feng and Zhang stated that the courts are willing to pierce the corporate veil in the interests of justice and to protect creditors’ interests.423 They have also stated that the courts pierce the corporate veil due to undercapitalisation even when there is a statutory absence of the veil-piercing doctrine.424 It is imperative to note that because China’s legal system is based on civil law, cases hold no precedent value. Thus, despite encouraging case law demonstrating courts piercing the corporate veil due to undercapitalisation, it is ultimately unclear whether courts will pierce the corporate veil due to corporate abuse of undercapitalisation.425

422 Ibid.
423 Courts are allowed to decide in the interests of justice if a party has causes injury to another party and the former is at fault, Basic Principles of Civil Law in China (M E Sharpe Inc, 1991)
In summary, creditors are able to bring an action against shareholders under Articles 20 and 64 of CCL if there is any commingling of assets or if shareholders avoid debt-payment.\textsuperscript{426} In addition, courts in China have paid a close attention to other types of abuses which may also trigger corporate veil-piercing doctrine including avoiding legal contractual and statutory obligations and undercapitalisation although the law is unclear in respect of these other types of abuse.\textsuperscript{427}

The next segment will analyse and compare Australia’s and China’s veil piercing laws discussed in this Chapter, thereby determining which jurisdiction accords better protection for creditors.

\textbf{D Analysis and Comparison of Australia and China}

It is clear from the outset that Australia arguably accords better certainty and protection due to the wider range of legal avenues a creditor can seek against the owners of the company. As compared to Australia, China has only two statutory Articles and other types of avenues, which are unpredictable in

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terms of their chances of success as there is no certainty that a Chinese court will follow past decisions.\textsuperscript{428}

As mentioned, China has only recently enacted veil-piercing provisions via the CCL in 2006 to address the increasing numbers of abusing the corporate veil whereas veil piercing doctrine has been present in Australia since 1911.\textsuperscript{429}

China’s veil-piercing provisions are drafted vaguely and as noted above, there are limited circumstances on when courts can pierce the corporate veil and even then, creditors can only sue shareholders.\textsuperscript{430} Since China does not have the doctrine of judicial precedent (stare decisis), it is unclear whether other types of corporate veil abuses can be valid grounds for creditors to bring a claim against shareholders.\textsuperscript{431} Hence, creditors in China are poorly protected compared to Australia’s.

The author will discuss each of these points below, covering Chinese statutory ambiguity, Chinese limited legal avenues, the doctrine of judicial

\textsuperscript{430} Wen, above n 34, 345.
precedent (or rather lack thereof) and the ability to recover from only shareholders in China.

1 Chinese Statutory Ambiguity

CCL’s provisions on veil-piercing doctrine are ambiguous compared to Australia’s veil-piercing doctrine. This is because CCL provides very little guidance on the scope of piercing the corporate veil.\textsuperscript{432} There are no defined terms in the statute and it does not specify the circumstances in which the corporate veil may be pierced.\textsuperscript{433} Article 20 of CCL states that:

The shareholders of a company shall comply with the laws, administrative regulations and articles of association, and shall exercise the shareholder’s rights according to law. None of them may injure any of the interests of the company or of other shareholders by abusing the shareholder’s rights, or injure the interests of any creditor of the company by abusing the independent status person or the shareholder’s limited liabilities.\textsuperscript{434}

Where any of the shareholders of a company evades the payment of its debts by abusing the independent status of legal person or the


shareholder’s limited liabilities, and thus seriously damages the interests of any creditor, it shall bear joint liabilities for the debts of the company.435

The Article is unclear as to what constitutes ‘abusing independent status person or the shareholders liabilities’.436 Furthermore, the Article only states that when shareholders evades any debt-payment and causes injury to creditors, the shareholders are personally liable to the creditors.437 It is not certain whether the courts are only to consider this factor or any additional factors in deciding, whether to pierce the corporate veil.438

Article 64 of the CCL deals with commingling of assets by a sole shareholder.439 This provision does not state the circumstances nor evidence needed to prove that the personal assets are independent from the company’s assets.440

435 Ibid.
These provisions are also silent as to whether or not the existence of fraud is a factor that a court may consider.\textsuperscript{441} There is no explanation in the CCL whether fraud is a valid ground in itself or a pre-requisite to pierce the corporate veil.\textsuperscript{442}

Hence, the 2006 enactments in the CCL would seem to accord limited protection of creditors’ interests because there is lack of guidance and considerable uncertainty surrounding these provisions.\textsuperscript{443}

By contrast, in Australia, the courts have offered ample guidance on this issue.\textsuperscript{444} One such example is Besanko J in \textit{Bird Cameron} in which he listed what are essential factors when determining an agency relationship.\textsuperscript{445} His Honour noted that there must be evidence of control of a parent of the subsidiary and the parent has to treat its subsidiary’s profits as its own.\textsuperscript{446}

Also as mentioned previously, the courts in Australia have stated that in order for a court to pierce the corporate veil, a company has to be either a sham or mere façade concealing true facts.\textsuperscript{447} The circumstances listed by the courts in

\begin{footnotesize}
\begin{enumerate}
\item Dirk Hanisch, \textit{The Liability of Shareholders for Obligations of the Company in Germany and the People’s Republic of China} (LLM Thesis, City University of Hong Kong, 2007) 48.
\item Ibid.
\item \textit{ACN 007 528 207 Pty Ltd (in liq) v Bird Cameron (Reg)} (2005) 91 SASR 570.
\item Ibid 112.
\item \textit{Gilford Motor Co Ltd v Horne} [1922] Ch 935; \textit{Jones v Lipman} [1962] 1 WLR 832.
\end{enumerate}
\end{footnotesize}
both of these cases act as a guide for other courts when considering piercing
the corporate veil.\footnote{448}{Re Neo (Unreported, Immigration Review Tribunal, Metledge M, 30 July 1997); Dennis Willcox Pty Ltd v Federal Commissioner of Taxation (1988) 79 ALR 267.}

As a result, Australia arguably accords better protection for creditors’
interests because there is more guidance, which assists creditors regarding the
criteria of a veil-piercing factor when bringing an action against the

The next point is absence of the doctrine of judicial precedent in China.

2 The Doctrine of Judicial Precedent

Judicial precedent enables creditors to be reasonably certain whether their
action against controllers of a company will succeed. Since China has no
doctrine of judicial precedent, creditors are unsure whether their interests are
protected even though there has been success in bringing a claim against the
corporate veil. This translates into assurance and certainty to creditors so their
legal venture to seek redress from shareholders will most likely not be in
vain.
An example of judicial precedent was in *Pioneer v Yelnah*, mentioned earlier in which the court noted that it is insufficient to create an implied agency between a parent and a subsidiary even when there is excessive control.\(^{451}\) This decision was followed by a more recent case, *Bird Cameron*, in which Besanko J stated that ‘control itself cannot be a decisive indicator of agency’.\(^{452}\)

On the other hand, China is a civil law country therefore there is an absence of judicial precedent.\(^{453}\) Although several courts have been willing to acknowledge other abuses not listed in the CCL, these courts’ decisions do not bind the lower courts.\(^{454}\) Hence, creditors are uncertain about whether successful cases of other types of corporate veil abuses are a valid ground for them to bring an action in court.

The next point is Chinese creditors having limited legal avenues to sue owners of the company, as compared to Australia.

3 Chinese Limited Legal Avenues

As previously discussed in CCL, there are only two provisions that are related to veil-piercing doctrine: Articles 20 and 64.\(^{455}\) The CCL does not

\(^{451}\) *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 5 NSWLR 254 (SCNSW, Young J).
\(^{452}\) ACN 007 528 207 Pty Ltd (in liq) v *Bird Cameron* (Reg) (2005) 91 SASR 570, 224.
\(^{454}\) Wu, above n 377, 332.
state any other circumstances in which courts can pierce the corporate veil\textsuperscript{456}. This means that creditors in China can only sue in two circumstances, either when a shareholder avoids any debt-payment or when a sole shareholder commingles their personal and company’s assets.\textsuperscript{457} In cases where there is fraud, undercapitalization or agency, it is not specified in the CCL whether these are valid grounds for shareholders to bring an action to court.\textsuperscript{458}

On the other hand, as has already been noted, there are various circumstances that trigger veil piercing doctrine in Australia.\textsuperscript{459} In circumstance where the company is used as a sham or mere façade and prejudices creditors’ interests, creditors can sue the owner of the company for fraud.\textsuperscript{460} Agency is also one of the valid grounds that a court may consider when piercing the corporate veil.\textsuperscript{461} The \textit{Bird Cameron} case acknowledges that creditors can sue the parent company if they fail to recover any funds from the subsidiary based on an implied agency between parent company and subsidiary.\textsuperscript{462} Agency also applies when a shareholder or owner is controlling the company and owns its profits.\textsuperscript{463} Australian courts can pierce group companies if they find a

\begin{flushleft}
\textsuperscript{456} Ibid.
\textsuperscript{457} Hanisch, above n 441, 48.
\textsuperscript{458} Huang, above n 443, 762.
\textsuperscript{459} Lipton, above n 3, 41.
\textsuperscript{461} ACN 007 528 207 Pty Ltd (in liq) v \textit{Bird Cameron} (Reg) (2005) 91 SASR 570; \textit{Smith, Stone and Knight Ltd v Birmingham Corporation} [1939] 4 All ER 116; \textit{Spraeg v Paerson Pty Ltd} (1990) 94 ALR 679; \textit{Pioneer Concrete Services Ltd v Yelnah Pty Ltd} (1986) 5 NSWLR 254 (SCNSW, Young J).
\textsuperscript{462} ACN 007 528 207 Pty Ltd (in liq) v \textit{Bird Cameron} (Reg) (2005) 91 SASR 570, 112.
\textsuperscript{463} ACN 007 528 207 Pty Ltd (in liq) v \textit{Bird Cameron} (Reg) (2005) 91 SASR 570.
\end{flushleft}
holding company failed to prevent its subsidiary from insolvent trading, as discussed above and in Chapter II.\textsuperscript{464}

Thus, creditors in Australia arguably have better interest protection compared to Chinese creditors because veil-piercing doctrine in Australia encompasses more factors and situations in which creditors’ interests can be found to be prejudiced.

The final point to be discussed is the fact that creditors can only sue shareholders in China.

4 Creditors can Only Sue Shareholders in China

The veil-piercing doctrine in Australia applies to the controllers of the company, who are the directors and shareholders.\textsuperscript{465} This means that creditors can bring an action against both directors and shareholders if they have abused the corporate veil.\textsuperscript{466} Helen Anderson, an academic, has identified that ‘directors face personal liability so that the law can both correctly attribute liability to the party responsible for wrongdoing, either at common law or

under statute'. 467 This means that creditors in Australia can sue directors if they have committed any corporate abuse such as fraud. 468

Unlike in Australia, the provisions stated in CCL are only directed to shareholders. 469 In other words, creditors can only sue shareholders when the latter abuse the corporate veil. 470 The CCL is silent on whether creditors can sue directors who abuse the corporate veil. 471 It only states that the supervisory board can propose to remove directors if they violate any laws and does not state whether directors are personally liable if they have damaged creditors’ interests. 472

There appears to be no academic commentary on the possible avenues outside of the CCL for which creditors can sue directors who abuse the corporate veil. The commentary only focuses on ‘suing shareholders’ and there is no commentary on ‘suing directors’. 473 The author suggests the

468 Ibid.
reason for this is likely to be due to the fact that suing directors might be seen as undermining the state authority since SOE still tightly controls and influences China’s company’s decisions.474

Thus, creditors in China have limited protection if directors have abused the corporate veil. There are no provisions that allow creditors to have any standing to sue directors for abusing the corporate veil; hence creditors in China are only limited to suing shareholders for any corporate veil abuse.475

E Conclusion and Reforms

The introduction of statutory veil piercing in China represents a positive legal development because now creditors can seek legal recourse in the event any corporate veil abuse such as commingling of assets.476 Furthermore, the Law Commission of China stated that in certain circumstances courts can pierce the corporate veil if there is a need to protect creditors’ interests.477

However, Australia arguably provides better creditors protection in the event of shareholders’ or directors’ abuse compared to China. As noted above, creditors in Australia have more avenues to bring an action against the

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474 Wen, above n 34, 335.
476 Huang, above n 443, 761.
477 Cao, above n 374.
controllers of a company, such as fraud, agency and single economic unit.\textsuperscript{478} There is also certainty with bringing a claim due to the court’s guidance and the doctrine of judicial precedent.\textsuperscript{479} Further, creditors in Australia are also allowed to sue both directors and shareholders of a company as opposed to creditors in China, who can only shareholders are liable.\textsuperscript{480} Therefore, creditors in Australia are arguably better protected compared to China.

The author submits that the reason for such a great disparity between Australia’s and China’s creditors protection may be due to the Chinese lawmakers’ lack of experience.\textsuperscript{481} China’s legal development only began in the 1980s, which is only a short period for lawmakers to gain experience in order to draft laws.\textsuperscript{482} In Australia, on the other hand, where the laws were drafted as early in 1820s, and have been continually revised to a competent standard.\textsuperscript{483} Further, as previously mentioned, SOEs in China still have great and political influence in the country’s economic development.\textsuperscript{484}

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\textsuperscript{481} Wen, above n 34, 345.

\textsuperscript{482} Ibid.

\textsuperscript{483} Although the legislations drafted at this time were established through Acts of British Parliament, Australian drafters were already exposed to drafting legislation at this stage compared to Chinese drafters. Therefore in the 1980s, Australian drafters are learning to perfect the legislations to evolve together with today’s society whereas Chinese drafters have only began to learn to draft legislations, \textit{New South Wales Act 1823} (UK); \textit{Australian Courts Act 1828} (UK); Ian M L Turnbull, ‘Clear Legislative Drafting: New Approaches in Australia’ (1990) 11(3) \textit{Statute Law Review} 161, 161.

\textsuperscript{484} Wen, above n 34, 335.
\end{footnotesize}
own shares in most of the JSCs, thus, the laws may drafted in a way so that creditors cannot take action against state shareholders. 485

Apart from what appears to be fairly obvious legislative reform, the author suggests some reforms that may narrow the disparity between Australia’s and China’s creditors’ protection. Firstly, The SPC in China could provide clear guidance to lower courts on elements that courts should consider, for example, elements of commingling of assets necessary for piercing the corporate veil. Although these principles would not be binding on lower courts, it is unlikely that they would be completely ignored as the SPC are allowed to publish guiding cases for lower courts. 486 Although these cases will not be binding nor persuasive for future cases due to the absence of judicial precedent in China, the number of like cases decided with like outcomes will be a major development towards uniformity and may provide certainty for creditors. 487

Secondly, it is further submitted that the State Council could provide commentaries on other types of corporate abuses such as fraud and undercapitalisation before amending the CCL. This gradualist approach allows the Chinese companies be on notice about the possibility of interested parties such as creditors piercing the corporate veil in circumstances other

485 Ibid.
than those stated in the CCL.\textsuperscript{488} The Chinese economy also can be maintained at the same time by giving assurance to creditors and potential investors that there interests are likely to have some degree of protection from corporate veil abuse.\textsuperscript{489}

The above suggestions may narrow the disparity between Australia’s and China’s creditor protection and may provide more certainty and uniformity in veil piercing cases.

\textsuperscript{488} Ibid.

In sum, it is submitted that Australia arguably accords better creditors’ protection than China. This argument is supported by evaluation of both jurisdictions’ directors’ duties to prevent insolvent trading (Chapter II) and veil piercing provisions in (Chapter III).

The doctrine of limited liability and separate legal entity status was discussed in Chapter I, and its role as a shield of the controllers’ assets from any potential company’s creditors’ claims. Also discussed was how the creditors can still take action against the controllers when a director fails to prevent insolvent trading or when a controller has otherwise abused the corporate veil.

This thesis then discussed and evaluated Australia’s and China’s veil piercing doctrines arguing that Australia provides better veil piercing laws in protecting creditors’ interests. To this end, this thesis first analysed Australian and Chinese directors’ duties to prevent insolvent trading because a breach of this duty may result in the courts to piercing the corporate veil. The following Chapter then analysed Australia’s and China’s veil piercing laws and factors that may trigger courts to pierce the corporate veil.

In Chapter II, it was noted that directors in Australia and China have a duty to protect creditors’ interests when companies are near insolvency. This thesis then compared both jurisdictions’ insolvent trading laws with the addition of another jurisdiction, the US. This was a necessary addition because China has
a dearth of academic literature in the area of insolvent trading laws as noted in Chapter II. In addition, academics have claimed that China’s director’s duty to be honest when company is near insolvency is said to have modelled on the US directors’ duties in deepening insolvency theory.

Also noted in Chapter II was how CBL is vague about the circumstances in which a director is considered to have participated in insolvent trading as well as the fact that there are few guidelines for the courts to rule on insolvent trading disputes. Thus, making it highly unlikely for a creditor bringing a potential claim for a director’s breach due to the unpredictability of the laws, and because the compensation orders appear to be non-existent. The author then suggested that the reason for the apparent lack legal rights for creditors in this respect is because taking legal action to sue directors might undermine the state’s authority since SOEs still tightly control and influence China’s company’s decisions. 490

Due to the lack of academic discussion in China concerning insolvent trading laws, this thesis has compared the US position in lieu of China’s. The equivalent of Australia’s insolvent trading laws in the US is the deepening insolvency theory. Since the US’s deepening insolvency laws are non-statutory, there are no clear guidelines in establishing deepening insolvency as a cause of action. Different cases present different opinions of the necessary elements for such a cause of action, which would very likely cause confusion among creditors contemplating a potential action against directors.

490 See thesis’ Chapter II – Directors’ Duties (Insolvent Trading) page 50, footnote 218.
Thus, Australia arguably has better creditors’ protection in the area of directors’ duty to prevent insolvent trading.

One may then infer that this means that Australia provides better creditors’ protection than China in this area of law. However, it must be noted that although China’s laws are modelled on the US’s directors’ duty of deepening insolvency theory, the Australia and the US comparison is not an exact Australia and China comparison. As noted in Chapter II, China’s political system may lead the law to develop quite differently from the US. An accurate comparison can only be made between Australia and China as US law if Chinese courts adopt the same developments in the case laws as in the US on the issue of deepening insolvency, which of course remains to be seen.

In Chapter III, this thesis also compared Australia’s and China’s veil piercing doctrines and argued that Australia has better veil piercing provisions that protects the creditors’ interests.

Although China recognized the principle of limited liability and separate legal entity status in 1993, it was not until 2005 that veil piercing provisions were enacted into the CCL. This enactment represents a positive legal development to protect creditors from corporate abuses such as commingling of assets. These enactments are necessary in order to safeguard creditors’ interests in China’s rapidly changing corporate landscape due to economic developments.
Despite these developments, Australia arguably has better creditors’ protection in the event of shareholders’ or directors’ abuse of the corporate veil. The evaluation of Australia’s and China’s veil piercing laws in Chapter III shows that there is a great difference between both jurisdictions. China’s veil piercing laws are vague and limited compared to Australia’s. Judicial precedent is absent in China which leads to uncertainty as to when courts will pierce the corporate veil. Further, the laws are only enforceable against shareholders, hence the legal avenues for creditors are limited.

As stated in Chapter III, the difference between these two jurisdictions may be due to inexperienced lawmakers and to protect the state shareholders so that the creditors cannot take action against the state shareholders. It seems that the laws are protecting the SOEs because SOEs still have political influence in the economic development. The author has suggested some reforms to this poorly drafted enactment.491 The author has also suggested that the SPC should provide clear guidance to lower courts and that the State Council should provide more information regarding other types of corporate abuses such as fraud and undercapitalisation so that companies will understand that Chinese courts have the potential to pierce the corporate veil based on these circumstances. Both these ideas are based on a gradualist approach to avoid any political conflict between drafters and SOEs and at the same time protect creditors’ interests.

It is a positive legal development that Chinese creditors are more protected since CCL enacted the veil piercing provisions but there is still a lot of room

491 See thesis’ Chapter III – Piercing the Corporate Veil page 111.
for China to progress to ensure that creditors’ interests are better protected. The Chinese President, Xi Jinping has launched the anti-corruption campaign in November 2012, aimed at reducing and tackling corruption within the country.\(^{492}\) This presents an opportunity because the veil piercing provisions in the CCL may be further reformed or improved, for example, to deter directors from abusing the company for personal gains, thereby protecting creditors’ interests.

Based on the evaluation of present laws governing Australia and China, Australia arguably accords better creditors’ protection, thus if creditors such as foreign lenders or business partners are looking to invest in well protected market, Australia appears to be a better choice.

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