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Piercing the Corporate Veil of Shareholder in German, US and Georgian Legal Doctrine

The aim of the present article is to study the grounds and judicial practices of piercing the corporate veil in Germany and the United States, and to present the flaws and problems of the present doctrine in Georgia, while providing solutions and recommendations regarding respective issue.

The article generally discusses piercing the corporate veil as a concept, which focuses on the legal and economic approach of limited liability. Afterwards, it outlines positive and negative economic and legal dichotomy of limited liability. The article examines the forms of piercing the corporate veil in the US and German law doctrines, types of creditors, the main preconditions for the use of the doctrine and related judicial practice. Moreover, article compares and reviews the legislative regulation, its historical development and judicial practice of piercing the corporate veil in Georgia.

Keywords: *Piercing the Corporate Veil, Limited Liability, Separate Personality, Corporation, Undercapitalisation, Disregarding the Corporate Formalities, Commingling of Assets, Konzern Law.*

1. Introduction

The essential principles of corporate law, such as limited liability and separate personality, provide the so-called corporate veil[1] for a corporation,[2] whereby the corporation presents itself to third parties as a separate and distinct entity from its shareholders, and its liability is limited to assets of the corporation. Nevertheless, these principles are not absolute and piercing corporate veil is possible in exceptional circumstances.

Frequently, there are cases of misusing the principle of limited liability, such as intentionally leading company to insolvency, receiving profit by acting not in good faith, deceiving creditors, avoiding responsibility, fraud, etc.[3] Undoubtedly, frequent occurrence of such cases in practice demanded the establishment of the doctrine known as piercing the corporate veil. This concept allows creditors to pierce corporate veil in certain cases and demand direct liability of the shareholders in favour of corporate creditors.[4]

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1 In Georgia, the present name was established in 2009; *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 236 (in Georgian).

2 In present article, the concept of corporation, as the US Corporation implies only an association where the partner has limited liability. *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 14-17 (in Georgian).

3 *Burduli I.,* Authorized Capital and Its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 236 (in Georgian).

4 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 14-17 (in Georgian).

The 6th paragraph of Article 3 of Law of Georgia on Entrepreneurs indicates the direct liability of the shareholder in case one misuses the principle of limited liability,[5] though the content, framework of usage, types and common judicial practice are not defined precisely.

Therefore, the main aim of this article is to identify the fundamental and modern approach of the concept of piercing the corporate veil based on US and German practice, and to use comparative legal methodology to discuss the ongoing flaws of the principle in legislative and judicial systems of Georgia.

2. The Concept of Piercing the Corporate Veil

2.1. Legal and Economic Approach to Limited Liability

The limited liability principle has been the subject of debate since its inception. The most common, but not the unanimous opinion, is that limited liability is the main reason for the formation of modern capitalist economy.[6] Despite debates, the universal character of the corporate form today is limited liability, indicating its significant value as a unique instrument of contracting and financing.[7]

A company is often described as the union of contracts – "*nexus of contracts*" in economics. However, it would be more accurate to distinguish it as an union for contracts, "*nexus for contracts"*, since the company is rather clearly outlined with the later name as the counterparty in various contracts with employees, suppliers and clients, organizing the actions of these multiple persons through exercise of its contractual rights.[8] The corporation, which is enforced as a legal entity from the moment of registration,[9] participates in different types of relationships as an independent legal entity, separate from its shareholders. The core element of this principle is "*separate patrimony"*.[10] This later element involves a demarcation line between the shares of the corporation and the personal shares of shareholders.[11] Respectively, the corporation itself is authorised to manage property at its own discretion, including ~~to~~ selling and pledging to creditors. The main function of "*separate patrimony"* is recognised as "*entity shielding"* – protection of corporation through a veil, which ensures the property of the corporation to be confined by the veil from the private creditors of the shareholders.[12] Unlike "*entity shielding"*, limited liability ensures protection of shareholder by veil known as "*owner shielding"*. Thus, this form guarantees security of private assets of the shareholders from the creditors of a corpo-

5 Article 2.3., Law of Georgia on Entrepreneurs, ed. 06/06/2018, 28/10/1994.

6 *Freedman J.,* Limited Liability: Large Company Theory and Small Firms, The Modern Law Review, Vol. 63, № 3, 2000, 326-327.

7 *Armour J., Hansmann H., Kraakman R.,* The Essential Elements of Corporate Law: What is Corporate Law?, Harvard Law School, Discussion Paper № 643, 2009, 9.

8 Ibid, 6.

9 Article 8, Civil Code of Georgia, ed. 21/07/2018, 26/06/1996.

10 *Kraakman R., Davies P., Hansmann H., Hertig G., Hopt K., Kanda H., Rock E.,* The Anatomy of Corporate Law, A Comparative and Functional Approach, Oxford, 2003, 8.

11 *Armour J., Hansmann H., Kraakman R.,* The Essential Elements of Corporate Law: What is Corporate Law?, Harvard Law School, Discussion Paper № 643, № 7, 2009, 6.

12 Ibid, 9.

ration. Together, limited liability and separate personality develop a regime known as "*asset partitioning".*[13] Consequently, the influence of these principles towards creditors are contradictory, particularly, corporation creditor's right to claim only applies to the assets of the corporation, while the claim of shareholder's private creditor applies solely to the assets of the shareholder.[14]

According to *Richard Posner*, one of the founders of economic analysis of law, a corporate form is a natural solution, which means that law and business practice have developed in certain way, and got dealt with all the obstacles faced by the partnerships.[15] The economic effect of limited liability principle on private law relations is the subject of special consideration in legal literature.[16] It is assumed that limited liability is not a means for excluding the risks, but it causes shifting of the risk from an individual investor to voluntary or involuntary creditor, who carries the risk in case of failure of the corporation.[17]

2.2. The Positive and Negative Economic and Legal Dichotomy of Limited Liability

Based on economic and legal analysis, the principle of limited liability is a widely spread and accepted form in common law and continental European countries. Nonetheless, the group of scholars who believed that too much free usage of the mentioned principle by small corporations would cause undesirable results in future for business owners and creditors also, always existed. However, a second group of scholars, in contrary, believes that more individual entrepreneurs and partnerships shall change the form, as the reduction of access to limited liability will bring a bigger blow to economic development.[18]

Opposed to *Posner*, *Easterbrook* and *Fischel* consider that when limited liability firm fails, the loss is swallowed rather than shifted, because the shareholder loses its confined investment to creditor.[19] As mentioned above, *Posner* indicates that, within limited liability, the risk is transferred to the creditor, and in his opinion shareholder's right to limit his/her risk will always reflect to the risk of others, which in itself does not create a great moral threat. This result would have occurred in case of unlimited liability as well because shareholder's personal assets would eventually end, and in this regime, the creditor would have become the carrier of the risk as well.[20]

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13 *Armour J., Hansmann H., Kraakman R.,* The Essential Elements of Corporate Law: What is Corporate Law?, Harvard Law School, Discussion Paper № 643, № 7, 2009, 9.

14 *Kraakman R., Davies P., Hansmann H., Hertig G., Hopt K., Kanda H., Rock E.,* The Anatomy of Corporate Law, A Comparative and Functional Approach, Oxford, 2003, 8-9; *Makharoblishvili G.,*The Two Differentiated Elements by the Corporation's Legal Personality: Limited Liability and Entity Shielding, Jubilee Collection: Guram Nachkebia — 75, *Todua N.* (ed.), Tbilisi, 2016, 435-437 (in Georgian).

15 *Posner R.,* Economic Analysis of Law, 8th ed., New York, 2011, 535-536.

16 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 58 (in Georgian).

17 *Posner R.,* Economic Analysis of Law, 8th ed., New York, 2011, 536.

18 *Freedman J.,* Limited liability: Large Company Theory and Small Firms, The Modern Law Review, Vol. 63, № 3, 2000, 327.

19 Ibid, 329.

20 Ibid.

At the same time, it should be taken into consideration that the possibility of diversified portfolio derives from the nature of limited liability of the corporations. The investor holds less risk while having a diversified portfolio, in contrast to investing only in one corporation, because in case of the failure of the corporation, the investor would lose the entire property. Moreover, the existence of a diversified portfolio leads investors to invest in risky projects by avoiding placing entire property under one risk.[21] Without limited liability, the investor would not have been able to plan diversified investments, since one would have been liable-with all of his/her assets.[22]

In addition to this, reduction of monitoring costs is a major economic justification, which eventuates from limited liability. Under unlimited liability, the creditor would have made a claim against the shareholder with the most assets in an insolvent company. In such case, the shareholder would have been forced to control every step of the managers,[23] which would result in increased costs of management monitoring and prevent investments. At the expense of the deduction of monitoring costs for shareholders and management and diversification of investments, it is possible to increase the capital of the corporation, which has positive impact on corporation.

Consequently, economic analysis of limited liability is based on the ability of the enterprise to transfer risks to creditors. In this sense, the principle of limited liability is a mechanism of insurance for corporation risks, whose value is paid by the creditor.[24]

2.3. The Nature of Piercing the Corporate Veil

2.3.1. General Overview of Piercing the Corporate Veil

The protection obtained as a result of the combination of principles of limited liability and separate personality is not unconditional and in some cases, when shareholders abuse them, restriction of such principles is applied, which is known in the USA as piercing the corporate veil and in Germany as *Durchgriffshaftung* (literal translation is as follows: pierce through responsibility).[25] Piercing the corporate veil was developed by the judicial system of the United States, which implies that shareholder may be individually liable for damages caused by corporations to creditors in spite of its limited liability.[26] It shall be noted that piercing the corporate veil mainly concerns closely held corporations, not the widely held ones. The Georgian translation of the Doctrine *Gamtcholi Pasukhismgebloba,* which was achieved by piercing the corporate veil, has been established in 2009.[27]

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21 *Posner R.,* Economic Analysis of Law, 8th ed., New York, 2011, 535-536.

22 *Orn P.,* Piercing the Corporate Veil – a Law and Economics Analysis, University of Lund, 2009, 13.

23 Ibid, 12.

24 *Sommer J. H.,* Subsidiary: Doctrine without a Cause?, Fordham Law Review, Vol. 59, Issue 2, 1990, 230.

25 *Burduli I.,* Authorized Capital and Its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 236 (in Georgian); *Burduli I,* Fundamentals of Corporate Law, Vol. I, Tbilisi, 2010, 165 (in Georgian).

26 *Matchavariani S.,* Management of Corporate Groups in Germany and the United States and Integration of Management Principles in Georgian Private Law, Tbilisi, 2015*,* 150 (in Georgian).

27 *Burduli I.,* Authorized Capital and Its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 236 (in Georgian).

The doctrine of piercing the corporate veil is used by the courts in the United States, in spite of the fact that restriction of limited liability is not regulated under the law. In such cases, courts of equity will pierce fictions, disguises and consider the contents of the actions and not blindly follow the corporate form of limited liability.[28] One of the earliest court judgments was made in the case of *Booth v. Bunce*,[29] where the court indicated that the corporate veil would have been pierced if the corporation was created to deceive and mislead creditors. The majority of courts use piercing the corporate veil only in cases when it was impossible to distinguish between individuality of the corporation and shareholder as personal interest and assets were excessively united.[30] The Court ruled in the case of *United States v. Milwaukee Refrigerator Transit Co.*[31] that corporate form might be neglected in cases where its form is used as a means of doing injustice, fraud, crime and breaking public order.[32]

Supporters of the doctrine of "parallelism of power and liability in Germany", followers of the Freiburg Economics School, argued that those who were in power in economic process should be liable for their actions as a corrective for such power. It was believed that such ~~a~~ narrative of liability would cause more cautious and responsible allocation of capital in the market.[33]

The judgement in *Rector*[34] made by the Supreme Court (*Bundesgerichtshof*) in 1966 indicated that there was no abuse of the limited liability principle and the co-existence of this principle and supervision of the management by shareholders is acceptable. However, the existence of additional circumstances that mislead the creditor regarding the extent of the liability and financial status of the shareholder allows courts to hold shareholders personally liable despite limited liability.[35] Consequently, in order to impose piercing the corporate veil, it is necessary to have specific circumstances such as creating corporation as the facade aimed at concealing a real picture, namely, representation, fraud and injustice, during which it is compulsory to assess a corporation and its shareholders as one whole.[36]

In contrast to traditional narrative of piercing the corporate veil, where a shareholder is liable for the damages of a corporation and parent corporation for its subsidiaries, reverse piercing indicates cases in which a corporation is liable for shareholders' liabilities, while subsidiary is liable to its parent

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28 *Bangor Punta Operations, Inc. v. Bangor & Arrostook R. R. Co.,* 417 U.S. 703, 713 (1974), *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 481.

29 *Booth v. Bunce* 33 N.Y. 139 (1865).

30 *Ezzo R. P.*, Corporations, Piercing the Corporate Veil, Stockholder Liability, University of Miami Law Review, № 122, 1957, 123.

31 *United States v. Milwaukee Refrigerator Transit Co.,* 142 F. 247, 255, C.C.E.D. Wis. (1905).

32 *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 481.

33 Ibid, 485.

34 Bundesgerichtshof, W. Ger., 45 BGHZ 204 (1966).

35 *Schiessl M.,*The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 485.

36 *DHN Ltd v Tower Hamlets* 1 WLR 852, Lord Denning MR14 (1976); *Adams v Cape Industries* plc., BCC 786, 822. 50. (1990).

corporation. In spite of the differences, reverse piercing requires similar preconditions as traditional piercing.[37] Furthermore, there is a distinction between vertical and horizontal piercing the corporate veil. Vertical piercing holds a shareholder liable for the debts of the corporation while horizontal piercing involves liability of the related (affiliated) corporations for the obligation of related corporation.[38]

Hence, the principle of limited liability and separated personality is not an absolute category. Those who will use privileges deriving from these principles for personal interests, which generally results in the wrong redistribution of economic risk, as a rule will pay for such action. In such cases, the legal response mechanism is piercing the corporate veil, though it should be noted that the goal of piercing the corporate veil is not to restrict limited liability, but it is the mandatory need for the protection of public interests.[39]

2.3.2. Types of Creditors of Piercing the Corporate Veil

Within the scope of doctrine of piercing the corporate veil, the difference is made between voluntary (contractual) and involuntary (tort) creditors.[40] According to *Richard Posner*, the principle of limited liability is not an enhanced and unjustified financial risk for contractual creditors.[41] Since the voluntary creditor, unlike the involuntary creditor, has the opportunity to study the corporation and its financial condition, until ~~a~~ the creditor makes a deal with the corporation, unless there is a case of fraud or misleading the creditor.[42]

It is noteworthy that there is no division between voluntary and involuntary creditors in Germany, as it is in American jurisprudence. The court should not pierce the corporate veil, when the contractual creditor has the knowledge of the financial condition of the corporation and still voluntarily concludes the contract with it.[43] In case of involuntarily creditors, the same prerequisites are to be used as for voluntary creditors.[44]

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37 *Allen N.,* Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice, St. John's Law Review, Vol. 16, № 1, 2012, 26.

38 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 21 (in Georgian).

39 *Makharoblishvili G.,* The Two Differentiated Elements by the Corporation's Legal Personality: Limited Liability and Entity Shielding, Jubilee Collection: Guram Natchkebia ― 75, *Todua N.* (ed.), Tbilisi, 439 (in Georgian).

40 *Burduli I.,* Authorized Capital and Its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 257-259 (in Georgian).

41 *Posner R. A.,*The Rights of Creditors of Affiliated Corporations, The University of Chicago Law Review, Vol. 43, № 3, 1976, 503.

42 *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 255-257 (in Georgian).

43 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 210.

44 *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 257-259 (in Georgian).

3. The Grounds of Piercing the Corporate Veil in US and German Legal Doctrine

The burden of proof is significantly hard on the party demanding piercing the corporate veil, as the role of limited liability is of high importance.[45] The American common law has established certain preconditions for imposing piercing the corporate veil, such as domination and control that may be expressed by commingling of assets between corporations and shareholders, disregarding corporate formalities, undercapitalisation, etc.[46] It shall be noted that the doctrine has same general preconditions in Germany too, namely, commingling of assets, dismissing corporate formalities and inadequate capitalisation.[47]

3.1. Control and Domination

Dominance and control means more than ordinary relationships between shareholders and companies. Parent corporations and dominant shareholders are always actively involved in the corporation's activities which is usually permitted and does not result in personal liability. Acceptable involvement includes monitoring and supervising of the finances and capital of the subsidiary corporation, expressing views concerning general policy and procedures of the corporation.[48]

Instrumentality and the alter ego theories are the mechanisms for determining domination and control.[49] The courts have developed multi-pronged mechanisms, including three-stage standard for instrumentality theory[50] and two-stage standard for the alter ego theory.

3.1.1. Alter Ego Theory

According to alter ego theory, there are two preconditions that must exist together in order to pierce corporate veil. First, the assets and interests between the corporation and the controlling shareholder are so united that it is impossible for the corporation to have a separate personality.[51] Secondly, assessment of such corporation as a separate legal entity based on the afore-mentioned facts would have resulted in fraud and unfair consequences.[52]

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45 *Smith D. G.,* Piercing the Corporate Veil in Regulated Industries, George Mason Law & Economics Research Paper, № 08, 2008, 5.

46 *Tchanturia L.,* Piercing Liability of the Shareholder for Tax Infringement of the Corporation (Innovation of Common Law), Jubilee Collection: Guram Nachkebia — 75, *Todua N.* (ed.), Tbilisi, 2016, 414 (in Georgian).

47 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 95 (in Georgian).

48 *Smith D. G.,* Piercing the Corporate Veil in Regulated Industries, George Mason Law & Economics Research Paper, № 08, 2008, 7.

49 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 69 (in Georgian).

50 *Bainbridge S. M.,* Abolishing LLC Veil Piercing, University of Illinois Law Review, Vol. 1, 2005, 87.

51 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within insolvency proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 69 (in Georgian).

52 *Figueroa D.,* Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America, Duquesne Law Review, Vol. 50, 2012, 728.

However, the majority of courts do not pursue piercing the corporate veil only on grounds of alter ego doctrine if there is no fraudulent act involved, despite the fact that the establishment of the corporation was aimed to avoid personal liability.[53] The claimant should prove that dominance and control by the parent corporation is so big that the subsidiary corporation has no independent legal significance and cases of fraudulent acts are present which mislead creditors regarding the identity of the corporation.[54]

3.1.2. Instrumentality Theory

The New York Court of Appeal was one of the first to establish an instrumentality test in the case of *Lowendahl v. Baltimore & Ohio Railroad Co.*[55] There is a three-part approach within instrumentality theory, which includes requiring the claimants to prove the following circumstances: 1) the level of control of the corporation by the defence party, which includes the complete dominance of the financial and business management of the corporation in a way that it no longer has a separate opinion, desire, therefore, it does not exist; 2) such control is used to infringe plaintiff's rights or to conduct fraud; and 3) the controlling and breaching the rights of the claimant were the cause of the damage.[56]

It should be noted that when the created corporation is only a blanket shell and it does not contain any assets, space or employees,[57] and the shareholder monitors and dominates its finances and management[58] that causes damage to creditor, then it is possible to use piercing the corporate veil doctrine.

Control and dominance, which is common in alter ego, as well in instrumentality theory, is largely relieved in the form of improper capitalisation, disregarding corporate formalities and commingling of assets.

3.2. Undercapitalisation

3.2.1. USA

The law does not the regulate matter of minimal capital in the United States, nevertheless undercapitalisation is not an accepted norm and it is considered that insufficient capitalisation is a problem beyond regulation. The courts have determined that capital should not be "inadequate", grossly inadequate or purely nominal.[59]

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53 *Ezzo R. P.*, Corporations, Piercing the Corporate Veil, Stockholder Liability, University of Miami Law Review, № 122, 1957, 122-123.

54 *Smith D. G.,* Piercing the Corporate Veil in Regulated Industries, George Mason Law & Economics Research Paper, № 08, 2008, 7.

55 *Figueroa D.,* Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America, Duquesne Law Review, Vol. 50, 2012, 721.

56 *Bainbridge S. M.,* Abolishing LLC Veil Piercing, University Of Illinois Law Review, Vol. 1, 2005, 88.

57 *Shapoff v. Scull,* 222 Cal. App. 3d 1457, Cal. Ct. App. (1990).

58 *Figueroa D.,* Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America, Duquesne Law Review, Vol. 50, 2012, 721.

59 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 202-203.

The state of California civil practice has established precise circumstances resulting undercapitalisation in business litigation cases.[60] The first one is when a corporation is organised and maintains its business activity with insignificant capital, meaning that the corporation does not have enough assets to cover its debts. Secondly, the corporation conducts business but does not possess enough financial resources to satisfy claims of creditors. Third, the shareholders have failed to put unencumbered capital under the risk of the business, which would have been reasonably adequate for future liabilities.[61] The fourth, the corporation owns capital that is illusory or trifling in comparison with the business it carries and the risk it holds. The afore-mentioned cases constitute the basis for denying the corporation as having a separate personality.[62]

In case of *Mobile Steel Co.,*[63] where shareholders owed debts to its creditors, the court rejected the concept that a shareholder is required to fill the capital of the corporation constantly to ensure the existence of the corporation. The court at the same time pointed out that adequate capitalisation is considered when a *bona fide* shareholder with general education on specific business and its accompanying risks sets reasonable capitalisation, taking into account other specific circumstances for establishing the company. Such approach is important as it focuses on the founding shareholder, and ensures more precise standards to determine undercapitalization.[64] Therefore, only plain signs of undercapitalisation are not sufficient for imposing alter ego liability and piercing the corporate veil.[65] However, undercapitalisation can become the ground for piercing the corporate veil when it was aimed for misusing the corporate form.[66]

The court in *Tanzi v. Fiberglass Swimming Pools, Inc.,*[67] case confirmed undercapitalisation as the capital of the company consisted of 3,000 dollars, while annual income amounted to 20,000 dollars. At the same time, the court found the full control of the shareholders over the company and assessed the debt they have given to the corporation as a refinancing of the capital, not a *bona fide* loan. In the case of *Sabine Towing & Transportation Co. v. Merit Ventures, Inc.*[68] the court disregarded the principle of limited liability, as the company that was operating in maritime shipping, refinanced its capital with 300,000 dollars, despite the fact that director with specific knowledge in this business advised the capital of 800,000 dollars.[69]

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60 *Stubbs L.,* Undercapitalization as an Independent Ground for Shareholder Liability: The Case for Corporate Stakeholders, Dalhousie University Halifax, Nova Scotia, August, 2016, 79.

61 Ibid.

62 "If the capital is illusory or trifling compared with the business to be done and the risks of loss", *Automotriz etc. De California v. Resnick*, 47 Cal.2d 792 (1957).

63 *In re Mobile Steel Co.,* 563 F.2d 692, 5th Cir. (1977).

64 *Gelb H.,* Piercing the Corporate Veil – The Undercapitalization Factor, Chicago-Kent Law Review, Vol. 59, Issue 1, 2013, 17.

65 *Gartner v. Snyder,* 607 F.2d 582, 588, 2d Cir. (1979), in: *Bainbridge S. M.,* Abolishing LLC Veil Piercing, University of Illinois Law Review, Vol. 1, 2005, 90.

66 *Smith D. G.,* Piercing the Corporate Veil in Regulated Industries, George Mason Law & Economics Research Paper, № 08, 2008, 10.

67 *Tanzi v. Fiberglass Swimming Pools* Inc., 414 A.2d 484, 490, R.I. (1980).

68 *Sabine Towing & Transportation Co. v. Merit Ventures* Inc., 575 F. Supp. 1442 E.D. Tex. (1983).

69 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 204.

3.2.2. Germany

In some jurisdictions, it is traditionally considered that regulated minimum capital ensures the reduction of undercapitalisation of the corporation and less shifting of the risk from corporation to the creditor.[70]

Unlike the US jurisdiction, German Corporate Law requires a minimum capital of 25,000 EUR[71] for German close corporations (*GmbH*), excluding exceptional cases. The above-mentioned corporate form is the most common form in Germany. Economists generally consider that the minimum capital that is adequate for all businesses cannot be determined. However, flexible capital based on its business size and other factors is not stipulated by the law. Nonetheless, corporate shareholders are not authorised to shift all the remaining risks to creditors after meeting the defined minimum capital.[72]

Correspondingly, according to German law, a corporation's inadequate capitalisation is apparent when current capital is not sufficient for the corporation to carry on the activities with the help of certain financial aids, which will not ensure the repayment of the corporation's debts.[73]

Due to the minimum capital, Germans distinguish between nominal and material undercapitalisation.[74] The shareholders fail to meet the minimum requirement of nominal capital during nominal undercapitalisation, whereas material undercapitalisation involves insufficient refinancing of the capital, after meeting the minimum capital requirement stipulated by the law initially. The Ulmer formula is widely established for the assessment of material undercapitalisation. According to the formula, undercapitalisation is apparent when financial instruments, including loans of shareholders, are not sufficient or adequate comparing to the operated business.[75] However, on 16 July 2007, the German Federal Supreme Court in the case of *"Trihotel"* has changed its approach regarding piercing the corporate veil, in particular, when the corporation's assets are drained, and the corporation's "economic status is destructed". The court clarified that the corporate liability of the shareholder is out of question, and denied the liability of the partner of the LLC towards creditor in the case of material undercapitalisation. Liability can only be imposed in case of deliberate damage to the corporation itself.[76]

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70 *Petroševičienė O.,* Effective Protection of Creditors' Interests in Private Companies: Obligatory Minimum Capital Rules Versus Contractual and other Ex Post Mechanisms, Social Studies Research Journal, № 3(7), 2010, 214.

71 Limited Liability Companies Act — Gesetzbetreffend die GesellschaftenmitbeschränkterHaftung (GmbHG), 20/04/1892. Section 5 (1): "The company's share capital must amount to no less than twenty-five thousand Euros." The exception rule is regulated in GmbHG, <https://www.gesetze-im-internet.de/englisch_gmbhg/>, [30.09.2018].

72 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 207.

73 *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 248 (in Georgian).

74 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 207.

75 Ibid.

76 *Knappke T. C.,* No Liability of Shareholder for Material Undercapitalization of a GmbH, Newsletter Corporate Law, October, 2008, 6.

Based on the new approach of the court to impose personal liability of the shareholder elucidates that tort law protects the creditor more adequately.[77] Accordingly, the liability of the LLC's partner in favour of the creditor arises when the partner abuses the privilege of separate personality[78] and violates this principle.[79]

3.3. Disregarding Corporate Formalities

3.3.1. USA

Disregarding corporate formalities is visible when a corporation is established by ignoring the norms of law.[80] Limited liability in the US also concerns the "promoters of the corporation"[81] that form the corporation but are not yet shareholders. Such matter is known as de facto corporation, where promoters are personally liable for obligations of the newly established corporation, until the corporation is properly established. However, since there is no legally established corporation yet, there is no corporate veil which could be pierced.[82] Nevertheless, the liability may be imposed on the shareholders based on general principles of contract law and unjust enrichment. Besides, de facto corporation is not impeded to adopt actions of promoters conducted during the de facto state of the corporation as its own.[83]

The formalities of the corporation are as follows: general meetings of shareholders and board of directors, issuance of shares and fulfilling the preconditions of issuance, selection of directors and managers, accuracy of factual and legal refinancing of signed capital, legitimacy of corporate minutes of meetings and obeying formal conditions related to them.[84] Section 303 (b) of the United States Uniform Limited Liability Company Act 1996 determines that "the failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company."[85] However, it should be noted that the violations of these

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77 *Zhen Qu C., Ahl B.,* Lowering the Corporate Veil in Germany: a Case Note on BGH 16 July 2007 (Trihotel), Oxford U Comparative L Forum 4, 2008, <ouclf.iuscomp.org>, [30.09.2018].

78 Limited Liability Companies Act, Gesetzbetreffend die GesellschaftenmitbeschränkterHaftung (GmbHG), Section 13 (2): "The company assets alone shall serve to discharge the company's obligations vis-à-vis its creditors.", <https://www.gesetze-im-internet.de/englisch_gmbhg/>, [30.09.2018].

79 *Görtz M.,* The Federal Court of Justice's Concept for Piercing the Corporate Veil due to Destruction of a German Limited Liability Company, Client Newsletter, № 9, 2007, 1.

80 *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 251 (in Georgian).

81 "A person who devises a plan for a business venture; one who takes the preliminary steps necessary for the formation of a corporation." The Free Dictionary by Farlex, <https://legal-dictionary.thefreedictionary.-com/promoter">promoter, [30.09.2018].

82 *Figueroa D.,* Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America, Duquesne Law Review, Vol. 50, 2012, 743.

83 Ibid.

84 *Burduli I.,* Authorized Capital and its Functions, Collection: Theoretical and Practical Issues of Contemporary Corporate Law, *Elizbarashvili N.* (ed.), Tbilisi, 2009, 251 (in Georgian).

85 Sec. 303 (b), Uniform Limited Liability Company Act, 12/07/1995.

formalities are only relevant when it leads to unlawful control and manipulation by the corporation shareholder.[86]

A shareholder is personally liable due to disregarding corporate formalities when such actions mislead a creditor regarding the debtor's identity. In particular, the creditor believes that he/she has a relationship with one company though another corporation is a real debtor. In *Morgan Bros., Inc. v. Haskell Corp.,* the court has decided to pierce the corporate veil, since the two corporations may not be separated from each other when the creditor contacts to the subsidiary company and the parent corporation gets directly involved in correspondence, respectively, the creditor believes that he/she is dealing with the parent corporation. Thus, the inability of following formalities has led to the impossibility of perceiving the subsidiary company as a separate legal entity.[87] Consequently, disregarding the corporate formalities plays an important role in determining the alter ego, as it is related to the separate personality of the corporation.

3.3.2. Germany

In Germany, like in United States, the court may pierce the corporate veil in case shareholder and the corporation do not protect corporate formalities, which lead to an incorrect assessment of the identity of the corporation by the creditor.[88]

The Numberg Regional Supreme Court and the German Federal Supreme Court do not have a uniform approach to the above-mentioned precondition for piercing the corporate veil. The former believes that if the corporation and shareholder cannot be distinguished between each other due to the inability of the shareholder to protect formalities, then the creditor's claim must be satisfied, even though there was no intention to mislead him/her. The latter considers that it is necessary to verify the circumstance that the creditor was not misled.[89]

Commentators use the name "*Sphaerenvermischung"* to refer to the fact when the identity of the corporation is uncertain, which was caused in above-mentioned court disputes due to failure to protect formalities.[90] It is noteworthy that just disregarding corporate formalities generally is not the ground for piercing the corporate veil, but violation of formalities, which cause more severe and undesirable result can be used as a ground to disregard limited liability.[91]

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86 *Smith D. G.,* Piercing the Corporate Veil in Regulated Industries, George Mason Law & Economics Research Paper, № 08, 2008, 8.

87 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 214.

88 Ibid.

89 Ibid, 214-217.

90 Ibid, 215.

91 *McGaughey R. J.,* Disregarding the Corporate/LLC Veil: The Most Litigated Issue in Corporate Law, Portland, 2007, 5-6.

3.4. Commingling of Assets

3.4.1. USA

In *Weeks v. Kerr* case, the court ruled that if the shareholder violated corporate formalities and used company as a channel for its personal profit, the court can also ignore the establishment of a legal entity in order to avoid unfair results.[92]

It is noteworthy that commingling of assets is often related to transferring of the assets, but unlike it the former involves the misuse of separate personality. Such picture is visible when the owner of the property cannot be determined. The inability of the corporation to protect separate personality causes losing its legal independence, resulting in considering corporation and shareholder as one subject.[93]

In order to impose piercing the corporate veil, it is necessary to have commingling of corporate accounting, records or accounts, which create the impression that a corporation and shareholder is one entity. If there is an illusion that the property belongs to the corporation, but in fact it is owned by the shareholder, then in case of bankruptcy, such assets will be assessed as the property of the corporation.[94] In *Re Kaiser* case, the court made the decision based on the above-mentioned principle.[95]

In *Penick v. Frank E. Basil, Inc.,*[96] the court refused to use piercing the corporate veil, as it found that the parent-subsidiary corporation was producing financial records separately, there was no commingling of assets and transactions between the corporations were made with "length of the arm."[97] Similarly, in *Amsted Industries, Inc. v. PollakIndustries, Inc.,*[98] where two corporations had a common shareholder, address, telephone, office and management, but maintained separate accounts, the court did not pierce the corporate veil.[99]

The claimant must also show the element of injustice and fraud since the fact of commingling of assets alone is not enough ground for piercing the corporate veil. For example, in *Palmer Trading, Inc.,*[100] the court found that the plaintiff had failed to prove the third stage of instrumentality theory, namely causality, which indicates that damage to creditor should be caused by defender. At the same time, it should be noted that the plaintiff filed a complaint against a related subsidiary instead of the parent corporation, which is not always unprofitable, when the transaction takes place between the subsidiaries and not by the dominance of the parent corporation.[101]

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92 *Weeks v. Kerr,* 486 NE2d 10, 12, Ind App (1985), *McGaughey R. J.,* Disregarding the Corporate/LLC Veil: The Most Litigated Issue in Corporate Law, Portland, 2007, 3.

93 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 145 (in Georgian).

94 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 211.

95 *In re Kaiser,* 791 F.2d 73, 7th Cir. (1986).

96 *In Penick v. Frank E. Basil, Inc,* 579 F. Supp. 160 D.C. (1984).

97 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 211.

98 *Amsted Industries Inc. v. PollakIndustries Inc.* 382 N.E.2d 393 Ill, App. Ct. (1978).

99 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 211.

100 *In re Palmer Trading Inc.,* 695 F.2d 1012, 7th Cir. (1983).

101 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 212-213.

3.4.2. Germany

The Federal Court of Justice of Germany in one of its decisions[102] stated that limited liability of the company may be neglected in case personal assets of corporation and the shareholder have been commingled.

The Karsluhe Regional Court rejected the corporation's limited liability as the shareholder announced its own property, among them several loans and house, as corporation's property, which was actually bankrupt. The court found that the shareholder failed to distinguish between two assets and could no more argue that the assets belonged to him/her. As a result, the court evaluated the shareholder and the corporation as one unity. In Germany, as in US, the bases for piercing are inaccuracy of financial accounting and records that make it impossible to distinguish the assets of corporations and shareholders from each other. Also, the property whose owner cannot be determined will be part of extended liability and the shareholder cannot claim the ownership on it.[103]

Piercing the corporate veil is not present in Germany when shareholder receives property owned by the corporation. In such situation, the corporation has the right to claim the property from shareholder, which caused inadequate reduction of capital in relation to corporate liabilities.[104]

4. Special Regulations

Piercing the corporate veil is regulated at the normative level in the USA and Germany. Such regulation is indicated in Comprehensive Environmental Response, Compensation, and Liability Act (hereinafter, referred to as *CERCLA*) in USA, whereas in Germany the Joint Stock Corporation Act regulates affiliated entities by *Konzern* law. In some cases, general principles of tort law from German civil law are applied.[105]

4.1. USA

4.1.1. *CERCLA* Comprehensive Environmental Response, Compensation, and Liability Act

CERCLA, also known as *Superfund*, came into force in 1980 to create federal regulation for problems such as the presence of harmful substances in the environment. The majority of the courts agree that the two main objectives of the Act are to restore the place damaged by the harmful sub-

[102] BGH, 22 BGHZ 226. (1956).

[103] *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 215.

[104] Section 30-31 (1), Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG), 20/04/1892.

[105] "The same duty is held by a person who commits a breach of a statute that is intended to protect another person. If, according to the contents of the statute, it may also be breached without fault, then liability to compensation only exists in the case of fault." § 823 (II), Bürgerliches Gesetzbuch Deutschlands, 01/11/1937.

stances and claim reimbursement of the costs of damage from party who caused such damage.[106] *CERCLA* determines a definition of person, including any corporation and individual, but does not make a special indication about the personal liability of the parent corporation or the shareholder.[107]

The case of *United States v. Bestfoods*[108] has established a standard in which corporations and their shareholders' liability are stated. The court has determined that the shareholder is directly liable according to the sub-paragraph (a) of Section 10 of the *CERCLA*, if he/she is involved with the management of the corporation regarding the harmful substances matters or is liable indirectly by the traditional doctrine of piercing the corporate veil.[109] Corporate veil can be pierced if the use of corporate form is aimed at achieving an unlawful goal.[110]

4.2. Germany

4.2.1. Tort Liability

Paragraph 826 of German Civil Code[111] deals with tort liability ("*Sittenwidrigkeit"*) when intentional damage is made by violating economic or legal rules, which is contrary to moral standards. According to Section 2 of paragraph 823 of German Civil Code,[112] tort is used when private and public order, i.e., "*Schutzgesetz"*, which protects individuals from certain damage, is violated. To use Article 826 from German Civil Code, it is necessary to prove the intention of the shareholder.[113] The courts usually do not ask for evidence that the shareholders were actually trying to harm the creditors, but such conclusion is drawn from the presented objective facts.[114]

The German Imperial Court ("*Reichsgericht"*) ruled that the shareholders are imposed with tort liability when the decision of not financing corporation's capital properly, considering its business field, was a deliberate step so creditors would have been left unprotected during bankruptcy.[115] The

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106 *Klass A. B.,* CERCLA, State Law, and Federalism in the 21st Century, Southwestern Law Review, Vol. 41, 2012, 682.

107 *Bakst D. S.,* Piercing the Corporate Veil for Environmental Torts in the United States and the European Union: The Case for the Proposed Civil Liability Directive, Boston College International and Comparative Law Review, Vol. 19, Art. 4, 1996, 335.

108 *United States v. Bestfoods,* 524 U.S. 51, 52 (1998).

109 *De Blasi M.*, Liability of Parent Corporations, Officers, Directors, And Successors: When Can CERCLA Liability Extend Beyond the Company?, Arizona State Law Journal, № 46:0481, 2014, 481.

110 *United States v. Bestfoods,* 524 U.S. 51, 52 (1998).

111 "A person who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage.", § 826, Bürgerliches Gesetzbuch Deutschlands, 01/01/1900.

112 "The same duty is held by a person who commits a breach of a statute that is intended to protect another person. If, according to the contents of the statute, it may also be breached without fault, then liability to compensation only exists in the case of fault.", § 823 (II), Bürgerliches Gesetzbuch Deutschlands, 01/01/1900.

113 *Vandekerckhove K.,* Piercing the Corporate Veil: A Transnational Approach, Catholic University of Leuven Legal Faculty, 2007, 115.

114 Bundesgerichtshof ZIP 1992, 694, 1992; Bundesgerichtshof AG, 244, (1989).

115 *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 492.

German Federal Supreme Court ruled that Article 826 of the Civil Code of Germany is violated when shareholder of closed corporation which is not viable, continues to carry out business operations through the corporation despite the fact that it is unable to satisfy its liabilities.[116] Shareholders are also liable for putting off an announcement on bankruptcy, in order to increase the corporation's fund at the expense of creditors for the personal benefit, regardless of the corporation's condition.[117]

4.2.2. Culpa in Contrahendo

German courts also impose liability on parent corporations on the ground of *Culpa in Contrahendo*. In the framework of this doctrine, the parent corporation is liable when it is significantly involved in the signing process of the subsidiary corporation's contract, which misleads the second party or affecting the process crucially by taking into consideration only its interests.[118]

One of the categories of *Culpa in Contrahendo* is liability of the agent. At this time, an agent acting as a representative of one of the parties may be held liable if there is high interest during the signing process of the contract, or the other party has shown great trust to the agent. Unlike the US-based agent's doctrine, Germany's parent corporation is considered as an agent of the subsidiary corporation.

In several of its decisions, Federal Court of Germany stated that if a shareholder of the corporation is involved in the negotiation process and knows about the critical financial condition of the corporation, then the shareholder should notify the other party regarding the condition of the corporation, otherwise the creditor may bring claim against the shareholder in case of bankruptcy.[119] Commentators think that such decisions are supported if they are based on the significant trust of the creditor towards the shareholder. However, if a shareholder believes in his/her business decision, then in this case imposing personal liability within the *Culpa in Contrahendo* is beyond the scope of this doctrine. That is why Federal Supreme Court of Germany has explained that direct business interest means when shareholder manages the corporation as he/she would have managed his/her personal property.[120]

4.2.3. Konzern Law

The real codification regarding affiliated entities[121] law was implemented in 1965 as *Konzern* Law ("*Konzernrecht"*). *Konzern* Law, among other issues, regulates the liability of a corporation towards credi-

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116 Bundesgerichtshof, W. Ger., 1957 WM 460, 462 (1957); Bundesgerichtshof, W. Ger., 1979 NJW 2104 (1978), in: *Schiessl M.*, The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 492.

117 Ibid.

118 *Vandekerckhove K.,* Piercing the Corporate Veil: A Transnational Approach, Catholic University of Leuven Legal Faculty, 2007, 383.

119 Bundesgerichtshof, W. Ger., 1984 NJW 2284 (1984), in: *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 495.

120 Bundesgerichtshof, W. Ger., 1985 WM 1526, 1528 (1985), in: *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 495.

121 The present sub-paragraph concerns only widely-held corporation with the exception of the part of qualified de facto "Konzern".

tors. The 3rd book of Stock Corporation Act contains the rules on the conflict of interests in a group of corporations that require a special regulation according to the German legislature. The *Konzern* is created when on the one hand, there is one controlling corporation and on the other hand there are one or more controlled companies. Balance is violated when a majority shareholder has an interest in one or two corporations and there is a risk that dependent corporation is under the influence of another corporation.[122]

Control is revealed by the ownership of majority of shares. In the absence of a majority shareholder, control is considered the case when the minority conducts direct effect through contract or representation in the supervisory board.[123]

4.2.3.1. Contractual *Konzern ("Vertragskonzern")*

Within contractual *Konzern,* corporations select the agreement, considering the special legal regime of the group. There are many forms of contracts. Different agreements define different quality of economic and legal dependence, therefore, it is followed by different legal consequences.[124] Under the Domination contract ("*Beherrschungsvertrag"*), the subsidiary corporation confirms that its management will be conducted by the parent corporation. Thus, the controlling shareholder has the right to manage subsidiary company, taking into account the interests of parent and other affiliated entities, but shall not place the viability of the subsidiary corporation at risk.[125] There is also a profit allocation contract. Under both contracts, the controlling corporation is obliged to reimburse the annual losses to controlled corporation, which can be achieved if the controlling corporation creates reserve funds.[126]

In the absence of such agreements, German corporate law makes a difference between de facto and qualified de facto *Konzerns*, with the latter being developed by the commentators of the Federal Supreme Court of Germany.[127]

4.2.3.2. De Facto Konzern (Faktischer Konzern)

The corporations that are related in reality but do not have a contract, are de facto dependent on each other.[128] The imperative rules of the Stock Corporation Act[129] regulates de facto *Konzern* and obliges the parent corporation to reimburse the subsidiary any loss or damage caused by transactions where the parent

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122 *Vandekerckhove K.,* Piercing the Corporate Veil: A Transnational Approach, Catholic University of Leuven Legal Faculty, 2007, 36.

123 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 97 (in Georgian).

124 *Vandekerckhove K.,* Piercing the Corporate Veil, European Company Law, Vol. 4, Issue 5, 2007, 192.

125 *Schiessl M.,* The Liability of Corporations and Shareholders for the Capitalization and Obligations of Subsidiaries under German Law, Northwestern Journal of International Law & Business, Vol. 7, Issue 3, 1986, 497.

126 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 98 (in Georgian).

127 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 239.

128 *Vandekerckhove K.,* Piercing the Corporate Veil, European Company Law, Vol. 4, Issue 5, 2007, 192.

129 § 311, § 317, Aktiengesellschafts Gezets, 01/11/1937.

corporation was liable. To determine the damage, it is necessary to evaluate all the transactions carried out with the affiliated corporation and other legal entities where the parent corporation was involved.[130] Furthermore, it shall be explained whether the transactions were beneficial for the subordinated company.[131]

Therefore, within de facto dominance, the law defines that damages may be claimed only by a controlled corporation that must prove that certain transactions have resulted in respective damages. In most cases, it is difficult to say that the specific transaction was not beneficial for the controlled corporation and this exact transaction caused an unfortunate result. Consequently, commentators consider that the legal significance of de facto *Konzern* is less effective because of difficulty of burden of proof and the fact that it is allocated on controlled corporation.[132]

4.2.3.3. Qualified De Facto Konzern ("*Qualifizierter Faktischer Konzern")*

Since the Stock Corporation Act does not include closed corporations and societies, German courts spread same liability when the subsidiary corporation is a closely held corporation and the parent corporation is the widely held one.

Since the 1970s, German courts have clearly intervened and developed a separate doctrine known as qualified de facto *Konzern.*[133] However, in *Bremer Vulkan*,[134] which satisfied all the preconditions of qualified de facto *Konzern*,[135] the Federal Court affirmed the new approach, according to which the parent company's liability before the creditors of the subsidiary is allowed only in the case when interference of the parent company violates the autonomous existence of the subsidiary – "disastrous involvement".[136] Consequently, without sufficient explanation, the Federal Court changed its twenty years of practice and rejected the doctrine of qualified de facto *Konzern*.[137]

5. Piercing the Corporate Veil in Georgia

5.1. General

Piercing the Corporate Veil is actively discussed as the basis for imposing the personal liability of shareholder within the last decade in Georgia. The issue is studied both in theory and practice. Especially, the decisions made by the Supreme Court of Georgia has increased the interest towards the institute.

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130 *Alting C.,* Piercing the Corporate Veil in American and German Law — Liability of Individuals and Entities: A Comparative View, Tulsa Journal of Comparative and International Law, Vol. 2, Issue 2, 1995, 238.

131 Ibid, 239.

132 Ibid, 238.

133 *Graefe R. R.,* The Liability of Corporate Groups in Germany, Connecticut Law Review, Vol. 37, 2005, 795.

134 *Bremer Vulkan,* BGH Sept. 17, 2001 - II ZR 178/99 (2001).

135 *Graefe R. R.,* The Liability of Corporate Groups in Germany, Connecticut Law Review, Vol. 37, 2005, 799.

136 *Zubitashvili N.,* Liability of Shareholders for Corporate Obligations within Insolvency Proceedings – Exception Cases from Limited Liability Principle, Tbilisi, 2016, 100 (in Georgian).

137 *Graefe R. R.,* The Liability of Corporate Groups in Germany, Connecticut Law Review, Vol. 37, 2005, 800.

5.2. The Development of the Concept of Piercing the Corporate Veil in Georgia

5.2.1. The Law of Georgia on Entrepreneurs

The first edition of the Law of Georgia on Entrepreneurs, adopted on 28 October 1994, contained regulation regarding personal liability of shareholders. Namely, according to Article 3.4.,[138] shareholders were directly liable before the creditors, "if the form of limited liability was misused."[139] In particular, the abuse was considered "first and foremost commingling of assets or the undercapitalization of the company required for its functioning." Therefore, due to the terminology of the law, abuse could have been considered other cases as well.[140]

Under the Law on Entrepreneurs, adopted on June 9, 1999, the rule of piercing the corporate law has become more specific and the grounds for using the doctrine has been determined. In particular, abuse was considered "if there was no bookkeeping of accounting, which clearly defines which assets and obligations belong to which corporation."[141]

Under the Law on Entrepreneurs, adopted on March 14, 2008, the special framework of piercing the corporate veil has been replaced by the general abstract provision. Therefore, the definition of the term of misuse has been removed from the law,[142] which meant that courts have broad discretion to flexibly define and determine what the misuse is based on every specific case.[143] Obviously, it would have been impossible to define every single case by specifying the law. Consequently, according to this article, liability shall be imposed on the limited shareholder (limited partner, partner of the LLC and the shareholder of the JSC) in case one abuses the legal forms of limited liability.[144]

At the same time, it should be noted that the original version of the Law on Entrepreneurs included Article 17, which regulated *Konzerns* and affiliated entities. The article regulated that *Konzern* was present, if one enterprise participated in another enterprise with more than twenty-five percent.[145] In accordance with one of the paragraphs of this article, in case one enterprise held at least fifty percent of another enterprise in Georgia, then the principal enterprise (enterprise holding majority of shares[146]) had to reimburse annual losses of the non-principal enterprise (second collaborator enter-

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138 Article 3.4., Law of Georgia on Entrepreneurs, ed. 28/10/1998, 28/10/1994.

139 *Tchanturia L.,* Piercing Liability of the Shareholder for Tax Infringement of the Corporation — Attempt to Implement Piercing the Corporate Veil in Judicial Law, The Grounds of Civil Law in Georgian Judicial Practice, *Zarandia T.* (ed.), Tbilisi, 2016, 280 (in Georgian).

140 *Zubitashvili N.,* Evaluation Standard of Paragraph 6 of Article 3 of the Law of Georgia on Entrepreneurs, through the Doctrine of Piercing the Corporate Veil, Journal of Law, № 2, 2014, 107.

141 Article 3.4., Law of Georgia on Entrepreneurs, ed. 09/06/1999, 28/10/1994.

142 *Tchanturia L.,* Piercing Liability of the Shareholder for Tax Infringement of the Corporation — Attempt to Implement Piercing the Corporate Veil in Judicial Law, The Grounds of Civil Law in Georgian Judicial Practice, *Zarandia T.* (ed.), Tbilisi, 2016, 280 (in Georgian).

143 *Zubitashvili N.,* Evaluation Standard of Paragraph 6 of Article 3 of the Law of Georgia on Entrepreneurs, through the Doctrine of Piercing the Corporate Veil, Journal of Law, № 2, 2014, 107.

144 Article 3.6., Law of Georgia on Entrepreneurs, ed. 06/06/2018, 28/10/1994.

145 Ibid, Article 17.1., ed. 28/10/1994.

146 Ibid, Article 17.2.

prise[147]). Principal enterprise also had to compensate to outside shareholders the losses of the non-principal enterprise, which resulted from the agreements of the principal enterprise or other events, etc.[148]

This method is similar to the German *Konzern* Law, where the interference of controlling corporation and quality of control played a crucial role in imposing liability by piercing the corporate veil. Moreover, within the scope of the above mentioned article, in case of participation with seventy-five percent share, the law defined that the limited shareholders of the corporation are liable as solidary debtors together with the enterprise before non-principal enterprise and third parties. There would not have been a liability if the manager of the independent enterprise acted the same.[149] Consequently, like in German *Konzern* law, it was necessary to perform the fiduciary duties in good faith in Georgia as well. However, as a result of the reform of the Law on Entrepreneurs in 2008, Article 17 has been abolished and the issue of damaging creditors as a result of domination by one enterprise on another has remained without regulation.

5.2.2. Judicial Practice

The Supreme Court of Georgia made two decisions on 6 May, 2015. Based on enforced ruling of the criminal court, shareholders of limited liability company, among them director of the company, have been accused of deliberately avoiding payment of extremely large amount of taxes.[150]

The Court used the Article 3.6. of the Law on Entrepreneurs and did not consider an Article 992 of the Civil Code of Georgia and ruled out the tort liability, which was unexpected, as there was unlawful action, damage and causal connection. However, it should be noted that the Court of Appeals had satisfied the claimant's request with tort liability.[151]

The Supreme Court has given preference to Article 3.6. of Law on Entrepreneurs, which considers piercing the corporate veil. The court found that that the misuse of the limited liability form shall be widely interpreted and it shall cover cases, when the partner of the LLC aims to avoid the payments of taxes, i.e., a corporation is used as the means of undeclared income by the shareholder. Under Article 3.6. of Law on Entrepreneurs, the shareholder may be personally liable before the creditors for damages that occurred as the result of the afore-mentioned matter.[152]

At the same time, the court discussed the form of liability of the shareholder, as well. In spite of the fact, that the Court of Appeal used the solidary liability, which was also indicated as the form of liability in the 1999 edition of the Law on Entrepreneurs, the Supreme Court found that the form of vicarious liability was reasonable,[153] which lacked arguments in the ruling.

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147 Ibid, Article 17.2.
148 Ibid, Article 17.3.
149 Ibid, Article 17.4.
150 Decision of May 6, 2015 № AS-1307-1245-2014, Supreme Court of Georgia; Decision of May 6, 2015 № AS-1158-1104-2014, Supreme Court of Georgia.
151 *Tchanturia L.,* Piercing Liability of the Shareholder for Tax Infringement of the Corporation ― Attempt to Implement Piercing the Corporate Veil in Judicial Law, The Grounds of Civil Law in Georgian Judicial Practice, *Zarandia T.* (ed.), Tbilisi, 2016, 277 (in Georgian).
152 Ibid, 278.
153 Ibid, 279.

6. Conclusion

The main flaws and problems associated with the concept of piercing the corporate veil have been identified in the present article. Piercing the corporate veil restores fair balance, in particular, in case of relevant circumstances and imposes personal liability on the shareholder.

The practices of leading countries, such as Germany and the United States, shall be implemented in Georgia. It is necessary to use piercing the corporate veil doctrine accurately, which is possible with the general normative regulation of Law on Entrepreneurs and sharing methods and approaches based on practice by the legal systems of different countries.

Afore-mentioned approach would have ensured the rapid and correct development of piercing the corporate veil in Georgian legal space, which is mandatory because of the popularity of the doctrine. In conclusion, it should be noted that it is necessary to establish uniform approach of court practice, as well as frequent research with new perspectives in legal literature, considering the achievements of other countries.

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