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The Necessity Of Piercing Corporate Veil Doctrine In Uzbek Corporate Law

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ABSTRACT

This article discusses the distribution of liability risks of shareholderss and other controlling persons on corporate liabilities. Given the analysis of ex post and ex ante model of control over distribution of risks of civil turnover participants in common law and continental legal traditions. Also, considered problems of shareholders' liability on obligations of corporations in the Republic of Uzbekistan. A shareholder shall be held liable on a subsidiary basis for the obligations of the legal entity in case of insolvency, as a result of the member's wrongful acts. However, some mechanisms of such liability do not allow to resolve the issue fairly.

KEYWORDS

Piercing corporate veil, shareholder, corporation, subsidiary liability, tort, minimum capital, limited liability company, creditor, investment.

INTRODUCTION

The concept of a legal entity (corporation), separate from its participants (shareholders) is recognized in all developed legal orders of common and continental law. The evolution of a company (association of persons) as an independent legal entity (corporation) is undoubtedly one of the largest contributions of law to entrepreneurship and trade [1].

Thus, the main features of a corporate form of a legal entity are: 1) separate legal personality (separate property, bear rights and obligations on its own behalf), 2) limited liability of

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shareholders, 3) equity participation of investors, 4) delegated management (separation of property from management), 5) Transferable shares [2].

Uzbek law recognizes two corporate forms of legal entities: a joint-stock company and a private limited liability company (analog of German GmBH) - business corporations. Currently, they are the main forms business organizations, especially "private limited liability company" has become a standard form in the business environment.

Risk of abuse of corporate form and limited liability

However, members and managers of corporations - controlling persons (shareholders, managers) can abuse limited liability, the corporation can be used as a tool - a "corporate shield" that does not have an independent will: *mere instrumentality* or *alter ego*, *adjunct*, *agency*, *conduit*, *department*, *pocket*, *puppet*, *sham*, *shell* or *tool* (or a similar metaphor) of parent corporation or controlling person [3].

The actions of the controlling persons, which are contrary to law and order and good faith, can lead to the insolvency of the corporation and ultimately harm creditors. In such a case, the use of the privilege of limited liability to the detriment of the interests of creditors is contrary to justice. One of the responses of law and law enforcement practice to such an abuse of the privilege of limited liability was the application in modern corporate law of a number of highly developed legal orders of liability that extend to the personal property of its participants, through creditors 'penetration' of such property in order to make it an object of liability [4] (within the framework of a tort, abuse of rights).

The problem of protecting the interests of creditors from unfair actions of the controlling persons of the corporation

The Law of the Republic of Uzbekistan No. 531 of 20.03.2019 "On amendments and additions to certain legislative acts of the Republic of Uzbekistan in connection with the adoption of additional measures to improve the business climate in the country" in 2019 abolished the minimum requirements for minimal capital of business corporations in the Republic of Uzbekistan[5]. Apparently the legislator was "inspired" by the possibilities of economic freedom in the Anglo-American legal system. But the legislator is in no hurry to establish the appropriate mechanisms of the same Anglo-American law ex post control (for example, establishing the possibility of personal liability of corporation members in case of abuse of the corporate form) to prevent abuse of the corporate form and balanced distribution of risks. Such non-systemic blind copying of certain mechanisms of legal institutions without understanding the essence and functions of this institution is in no way an improvement in the business climate. This liberalization of the requirements for the statutory funds of corporations and the procedure for creating business entities without the introduction of subsequent control mechanisms creates favorable conditions for the abuse of the corporate form. Based on this, it is necessary to balance the system of subsequent control and distribution of risks of liability of participants in civil turnover.

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The arguments for creating the most favorable legal conditions for investors have nothing to do with an imbalance in the distribution of corporate liability risks between the corporation, creditors and participants. Under the pretext of maximum economic freedom, the minimum statutory requirements of corporations have been abolished. Although it is unlikely that "corporate dummies" with an authorized capital of 1 million uzbek soums (about 10 US Dollar) and one-day, in fact, do not have any (even minimal) capital, are able to really contribute to financial and economic development. As the experience of developed law and order shows, not such "empty" subjects determine the content and prospects for improving corporate legislation. Therefore, the requirement for a firm (including minimum) authorized capital of business entities remains one of the cornerstones of the corporate law of the continental European type. [6].

In order to limit the abuse of the corporate form, namely, the privilege of limited liability of the corporation by controlling persons, in developed legal systems for centuries ex post and ex ante models of control and constructions of liability of controlling persons for corporate debts have been developed. [7]. An effective mechanism of ex post control is the doctrine of the “piercing corporate veil” of removing the corporate veil, which provides for liability of participants for abuse of the corporate form (limited liability) and causing harm to creditors.

The construction of a legal entity with limited liability (corporation) is closely related to the construction of mechanisms for a balanced and optimal distribution of risks between the corporation, controlling persons (members / shareholders, directors, true beneficiaries) and creditors. The rule of law should provide fair rules of the game for the stability of civil (economic) turnover (in the event of a corporation's insolvency) by building balanced mechanisms for the distribution of responsibility, preventing unscrupulous persons from gaining benefit from their illegal actions and abuse. The creation of transparent and foreseeable legal regulation in this area is the most important condition for the stability of civil turnover.

It should be noted that the protection of creditors' rights is one of the main values of corporate law. In the science of corporate law and corporate practice, all mechanisms for protecting the rights of creditors and balancing the distribution of risks taking into account the limited liability of corporations have been formed.

And a fair distribution of risks between persons who control a legal entity and creditors (and other persons) is ensured ex ante by tools for establishing minimum capitalization requirements (the size of the authorized capital), preliminary checks during the creation of a corporation, requirements for the appropriate capitalization of the corporation, as well as ex post tools, such as the doctrine of withdrawal corporate cover, tort liability of controlling persons to creditors, etc.

Since the legislator has already abandoned ex ante control, such as establishing minimum capitalization requirements, checking the creation of a corporation, then ex post control mechanisms should be introduced, such as the doctrines of “piercing corporate veil” - the

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removal of corporate cover (Anglo-American law) or "penetrating liability" (continental legal traditions). Below we will discuss the features of the application of such responsibility in developed legal systema and Uzbek law.

In corporate law enforcement practice of developed legal systems, the basis for piercing the corporate veil is the presence of special circumstances indicating that a corporation, despite its seeming independence, is only a "facade", "tool", "shell", which hides the real facts and actions of its controlling persons. On this basis, corporation is disregarded and identified with its shareholder.

Moreover, an economic crisis is inevitable due to the spread of coronavirus infection, which will lead to an increase in the bankruptcy of business entities. This provision forces us to reconsider the distribution of liability risks, taking into account the unfair acts of controlling persons of business entities. Otherwise, the current regulation on the liability of controlling persons for the debts of companies does not allow to fairly distribute the risks of liability, to ensure that the rights and interests of bona fide creditors are protected from unfair acts of controlling persons.

Subsidiary liability of a participant (shareholder) for the company's obligations.

The structure of the liability of a participant / shareholder for the obligations of the company in Uzbek law is built on the subsidiary liability of a participant / shareholder [8].

At the same time, it is based on tort: responsibility is conditioned by the illegal actions of the participant, the onset of insolvency caused by these actions. However, this design implies other mechanisms that are completely unrelated and incompatible with it.

As follows from part 4 of art. 48 Civil Code on the shareholder may be entrusted with subsidiary liability for the obligations of a legal entity if the following conditions are met simultaneously:

In the event of insolvency (bankruptcy) and the insufficiency of the property of a legal entity to meet the obligation;

The insolvency was caused by the illegal actions of the founder (causal relationship between the insolvency and the illegal actions of the participant);

The founder has the right to give binding instructions to a legal entity and this right is established in the charter (or other constituent document);

The presence of intent on the part of the founder - if the founder used the specified right in order to commit an action by a legal entity, knowing that as a result of this, the insolvency (bankruptcy) of this legal entity will occur (that is, deliberately bringing to bankruptcy).

Now we will consider the grounds (mechanisms) of the construction of "subsidiary liability" separately [9].

A). Insolvency of the corporation

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The most important basis for subsidiary liability is the onset of insolvency (bankruptcy). This means the responsibility of the founder arises only if the economic court recognizes the inability of the legal entity in full to satisfy the claims of creditors for monetary obligations and (or) to performance obligations for mandatory payments. Accordingly, the legislator consistently links the insolvency of a legal entity with the insufficiency of property for its obligations.

The most interesting thing is that the legislator, in the context of this norm, puts a completely different content into the term "subsidiary liability": the responsibility of the founder is due to his fault and the right to give mandatory instructions. Of course, the author does not exclude the establishment and predetermination of subsidiary liability by such political and legal grounds.

However, the main problem in establishing such a provision of subsidiary liability is that it distracts attention from the classical compensation for losses in the form of tort or contractual liability of the relevant person, guilty of reducing the assets of a legal entity subsequently declared bankrupt. [10]. After all, if liability arises as a result of the guilty illegal actions of the founder, why is it impossible to resolve the issue of liability within the framework of a tort?

After all, subsidiary liability implies full responsibility to the creditor for the obligations of a legal entity, and the founder's fault may not correspond (rather, it does not correspond in most cases) with such a volume of responsibility.

In Germany, as already noted, as a result of the unlawful, guilty actions of the controlling person (including the founder / participant / shareholder), the corporation will lose its viability, he is liable to creditors within the framework of the rules on general tort in accordance with art. 826 German Civil Code (*Existenzvernichtungshaftung*) [11].

B). Participant's right to give binding instructions.

The main criterion for imposing subsidiary liability on a shareholder is that the shareholder has the right to give binding instructions to corporation. This means that if the right to give mandatory instructions is not established in the constituent documents, then the participant does not bear subsidiary liability for the company's debts.

It should be noted that this legal requirement does not correspond to the purpose of the design and is incompatible with it.

Apparently, the legislator intended to establish a control criterion - the decisive participation of a participant in the decision-making process. In all developed legal systems, the liability of a participant for the debts of a corporation arises if the first has significant control: rightly, the one who made the decision is responsible. For example, in the United States, excessive control is the most important reason for "taking off corporate cover" [12].

In fact, the predominant participation of shareholder in the corporation (if he owns a controlling block of shares, or is an executive body, etc.) in full measure makes it possible to decisively influence decision-making - to

control it. Accordingly, this in itself means that such a controlling person has the ability to harm others by abuse of the right, committing illegal actions, in a word, abuse the corporate form (privilege of limited liability) as a "tool", "pocket", "facade", "shell " etc.

Apparently, the legislator proceeds from the understanding of a tort - failure to fulfill an obligation that exists between the one causing harm and the victim.

As we noted above, the establishment of the right to issue binding instructions by an agreement or constituent document is rather borrowed from the German law of corporate groups (*Vertragskonzern*) [13].

However, this provision is only part of the German liability risk distribution system and the doctrine of "Penetrating Liability" (Durchgriffshaftung). In German law, there is a whole system of distribution of corporate liability, which allows to fairly assign the guilty participant responsibility for the obligations of the corporation.

C) Unlawful actions and causal relationship between participant / shareholder's unlawful actions and insolvency

Unlawful action refers to any action that contradicts the foundations of the rule of law. Unlawful actions are committed exclusively by violation of subjective rights, established norms. For example, tax evasion, hiding assets and not keeping records of assets, transferring assets to other affiliated companies in order not to pay obligations, sham transactions, etc.

Committing unlawful actions is a key basis for the subsidiary liability of a participant (shareholder). This is based on the fundamental principle of law - the principle of justice, according to which a person who behaves in bad faith or unlawfully should not be allowed to enjoy the benefits or advantages that he gains through such behavior.

D) Intention in the actions of the shareholder in relation to insolvency.

As follows from Part 6 of Art. 48 Civil Code the insolvency (bankruptcy) of a legal entity is considered caused by the founder (participant) or the owner, who has the right to give instructions binding on this legal entity, **only if he used this right in order to commit an action by a legal entity, knowing in advance that as a result of this, the insolvency (bankruptcy) of this legal entity will occur.**

The legislator establishes the presence of intent (direct or indirect) of the participant in relation to the bankruptcy of a legal entity as a basis for bringing subsidiary liability. And the systematic nature of the construction of "subsidiary liability" is violated: after all, the unlawful acts of the participant, regardless of intent, will lead to insolvency. And intent is unnecessary here and destroys the construction of liability. It can even be said that the legislator will thus make it impossible for the subsidiary liability of the controlling participant, without a court verdict on deliberate bankruptcy in accordance with art. 181^1 of the Criminal Code of the Republic of Uzbekistan.

Obviously, the legislator in this part has in mind the abuse of the right (causing harm as a result of abuse), which implies the presence of intent. However, abuse of the right constitutes an

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independent construction of liability and is incompatible with other mechanisms of subsidiary liability.

In recent years, the German Federal Court has changed its position regarding the liability of controlling persons within the framework of the "de facto concern" structure, and now the liability of controlling persons for unlawful, damaging actions of the company is resolved within the framework of a general tort [14].

Analysis of judicial practice on subsidiary liability of an LLC participant

a) The position of the Mirabad interdistrict civil court in case No. 2-1002-2006 / 91 (1-1388 / 20) [15] dated 09.03.2020 confirms the above arguments. The State tax inspectorate (STI, the plaintiff) filed a claim against A. Gonago, the only participant and director of Profit Trade System private limited company, to impose subsidiary liability on her for the debts of the bankrupt Profit Trade System PLC. By the decision of the economic court, the PLC was declared bankrupt and a case on the liquidation of the company was initiated. In addition, according to the plot of the case, a member of the corporation A. Gonago was found guilty of committing crimes provided for in art. 167,168 184, 189, 190, 209, 227, 228 and 243 of the Criminal code of the Republic of Uzbekistan, some crimes were related to the activities of corporation.

Thus, the court refuses to satisfy the imposition of subsidiary liability on the participant and justifies the refusal to satisfy the claim on the following grounds:

There is no causal relationship between the illegal actions of the participant and the insolvency of the corporation;

No proof of the participant's intent in relation to insolvency;

The right of the participant to give mandatory instructions to the company in the charter is not established.

Following the law, interpreting the norms of law, the court apparently made a legal decision. However, it should be noted that due to the unsystematic and flawed legal structure of the liability of persons controlling society:

The risk of liability is incorrectly distributed between the participant and the bona fide creditors;

The controlling participant is "encouraged" or not liable for damage caused as a result of his illegal actions;

An unfair shareholder got benefits from his illegal actions by using the privilege - "limited liability" of the company, which is intended for completely different purposes;

It is allowed to abuse the corporate form, using it as a "shell";

The rights and interests of creditors are not protected and are legally protected, which are less valuable than the rights of a private owner.

CONCLUSION

Thus, in Uzbek law, the provisions on subsidiary liability of a participant / shareholder (or the so-called "removal of corporate cover")

are fragmentary and scattered, rather than systemic. Moreover, most importantly, it does not ensure a fair distribution of risks, does not allow ensuring stability and does not deter unfair participants from abusing the corporate form (limited liability).

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