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TITLE

What are the major problems that impede Armenian Courts to disregard the corporate form outside intentional bankruptcy context?

The applicability of "piercing the corporate veil" doctrine in Armenia

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INTRODUCTION

The doctrine of "piercing the corporate veil" is a source of misperception and confusion. On the one hand, courts understand that the corporate form is a legal entity endowed with the characteristic of "legal personality." As such, courts recognize that their equitable authority to pierce the corporate veil is to be exercised "reluctantly" and "cautiously." At the same time, courts also are aware of the fact that it is perfectly legitimate to create a corporation or other form of limited liability business organization such as an LLC "for the very purpose of escaping personal liability" for debts incurred by the enterprise.[1]

Inconsistent with the "limited liability" nature of the corporate enterprise, the list of justifications for piercing the corporate veil is long, imprecise to the point of vagueness and less than reassuring to investors and other participants in the corporate enterprise interested in knowing with certainty what the limitations are on the scope of shareholders' personal liability for corporate acts. For example, veil piercing may be done where the corporation is the mere "alter-ego" of its shareholders, where the corporation is undercapitalized, where there is a failure to observe corporate formalities, or where the corporate form is used to promote fraud, injustice or illegalities.[2]

Analytically, the concept of limited liability is a simple, although profound, implication of the basic concept in corporate law that legal entities (such as corporations and limited liability companies) are separate and apart from their shareholders, directors and other constituencies[3]. Consequently, legal entity's assets are partitioned from those of shareholders'. One aspect of asset partitioning (defensive) is the delimitation of the extent to which creditors of an entity can have recourse against the personal assets of the owners or other beneficiaries of the entity.[4]

We can infer that as a result of the legal separateness, corporations and similar business entities can enter into contractual relations, sue and be sued in courts, hold duties of paying taxes and complying with laws and regulations. In other words, limited liability stands for the notion that a complete separation of identities exists between investors and the corporations in which

[1] Jonathan Macey and Joshua Mitts, Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil, Cornell Law Review, Volume 100, Article 2, Issue 1 November 2014, p.3
[2] ibid
[3] For ease of reference, the term "shareholder" will be used throughout the Paper.
[4] Henry Hansmann and Reinier Kraakman, The Essential Role of Organizational Law, The Yale Law Journal [Vol. 110] 2000, p. 390

they have invested. Put simply, the investors in the corporation are not liable for more than the amount they invested. Legal entities mentioned above internalize both the benefits and the burdens of limited liability attributes, being separate and distinct from their shareholders and other constituencies.

The perpetual dilemma and one of the most complex and controversial topics of corporate law is the co-existence of limited liability and "piercing the corporate veil" concepts. Virtually, limited liability shields the shareholders' assets and encourages them to make investments for business development. But what if the enterprise engages in excessive risk taking and fraudulent conduct by the decisions of its shareholders or directors? Do the shareholders enjoy absolute limited liability when obtaining credit by misrepresentation? Or what if the entity is a mere "alter-ego" of its shareholders?

Conversely, "piercing the corporate veil" rules protect creditors' rights. However, we can make an assumption that, to a certain extent, these two concepts introduce balance in the field of corporate law. When the specific grounds for disregarding corporate form are predictable, we can assert that piercing the corporate veil not only protects the rights of outsiders who deal with the enterprise but also raises shareholders' awareness of circumstances when they may be subjected to personal liability.

Additionally, the so-called piercing corporate veil "doctrine" is not a simple doctrine. It is rather a remedy than a mere theory, in that corporate veil-piercing actually protects post factum the interests of enterprise's creditors (voluntary and involuntary) from detrimental activities of its shareholders and directors. Besides, like any good remedy, the corporate veil is pierced in order to achieve specific policy objectives.

So, my task is to research the policy objectives we can potentially have in the Republic of Armenia (hereinafter referred to as "the RA") when disregarding corporate form, and to address the following specific research problems:

- *To pierce or not to pierce...?.*
- *What are the major problems that impede Armenian Courts to disregard the corporate form outside intentional bankruptcy context?.*

At the same time, there are some other problems that should be researched.

The key role in the corporate governance system in the RA belongs to shareholders and directors, and sometimes their decisions can result in the insolvency of the corporation.

Instructed by shareholders or its directors, the corporation may engage in excessively risky projects being undercapitalized, in fraudulent activities (conduct), or in misrepresentation when dealing with creditors. It means that the investments of lenders and other creditors' interests are at risk. So, absent the corporate veil-piercing rules, many creditors will refuse to invest money in the RA, which will adversely affect the economic and financial growth of the country.

Thus, the need to develop the doctrine in this field and to prescribe detailed corporate veil-piercing rules (legal grounds) in the RA Civil Code and in various laws on legal entities is justified by the above reasoning. Those legal rules should provide for a set of events, circumstances, conditions and requirements that will give an understanding of when and how the corporate form can be disregarded. Such rules will aim at ensuring that in case the enterprise becomes insolvent, the courts will grant creditors' corporate veil-piercing claims when the failure to repay the corporate debts was due to shareholders' or directors' wrongdoings (outside intentional bankruptcy context).

The Master's Paper examines some very important issues regarding constitutional rights of shareholders, as well as of other corporate constituencies, and civil remedies available to creditors in conjunction with analyzing the applicability and necessity of "piercing the corporate veil" doctrine in the RA legal reality.

This Master's Paper consists of Table of Contents, an Introduction, three Chapters, a Conclusion, and a Bibliography.

The Introduction presents some background information on the research topic, a general overview of the specific research problem and its significance, and the structure of the Master's Paper.

CHAPTER 1 encompasses the doctrines of limited liability and "piercing corporate veil", their advantages and drawbacks, and the interaction of these "contradicting" concepts.

CHAPTER 2 covers the tests used in corporate veil-piercing in the US aiming at providing grounds for a comparative analysis of the RA respective legislation and judicial practice.

CHAPTER 3 is designed to study the legislation of the RA concerning circumstances when the corporate form can be disregarded. Namely, all veil-piercing-related articles, relevant cases of the RA Cassation Court will be presented and analyzed. Finally, some major problems will be considered that impede the RA Courts to disregard the existence of corporate entity.

CHAPTER 3 is followed by a Conclusion concisely outlining the main findings of the research, providing a synthesis of key points and recommending new areas for further research.

Finally, the last section is the Bibliography, enumerating all the statutes, literature, articles, and case law studied for the Master's Paper.

Literature Review: This study is mainly based on the following literature:

Vandekerckhove K., Piercing corporate veil: A transnational Approach, (Kluwer Law International, 2007) - a comparative analysis of the substantive law on corporate veil-piercing in transnational context. It is an in-depth analysis of veil-piercing doctrines of France, the Netherlands, Belgium, Germany, the UK and the US.

*Neil A. Helfman**, Establishing Elements for Disregarding Corporate Entity and Piercing Entity's Veil*, American Jurisprudence Proof of Facts 3d, June 2016 Update*, which presents a historical overview of "piercing the corporate veil" doctrine and its evolution in the US case law. This article is a comprehensive examination of the law and presentation of proofs in support of the elements required to pierce an entity's protected veil. It encompasses both the relationship between an individual owner and an entity, and a parent entity and its subsidiary.

Jonathan Macey and Joshua Mitts, Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil, Cornell Law Review, Volume 100, Article 2, Issue 1 November 2014 - This article developed a new theoretical framework maintaining that veil piercing is done to achieve three main public policy goals, each of which is consistent with economic efficiency: (1) achieving the purpose of an existing statute or regulation, (2) preventing shareholders from obtaining credit by misrepresentation, and (3) promoting the bankruptcy values of achieving the orderly, efficient resolution of a bankrupt's estate. It demonstrates that a supposed justification for veil-piercing, undercapitalization or other factors, taken independently, rarely, if ever, provide a basis for piercing the corporate veil.

Frank H. Easterbrook and Daniel R. Fischel, Limited Liability and Corporation, University of Chicago Law School, Journal Articles, 1985 - This article introduces us to limited liability - a fundamental principle of corporate law. The authors claim that limited liability has never been absolutely limited. Courts occasionally allow creditors to "pierce the corporate veil," which means that shareholders must satisfy creditors' claims. According to them, there is a consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law.

Henry Hansmann and Reinier Kraakman, The Essential Role of Organizational Law, The Yale Law Journal [Vol. 110] 2000 - It addresses the question regarding the role of organizational law in modern society, developing the concept of asset partitioning, both affirmative (the shielding of the assets of the entity from claims of creditors of the entity's owners or managers) and defensive (the extent to which creditors of an entity can have recourse against personal assets of owners or other beneficiaries of the entity - " limited liability").

Palmiter & Partnoy, Corporations: A Contemporary Approach (West 2010), which focuses on the role of corporations in contemporary society.

Additionally, other articles used for this Paper are: *Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 Cornell L. Rev. 1036 (1991), Jimerson & Cobb P.A., The Five Most Common Ways to Pierce the Corporate Veil and Impose Personal Liability for Corporate Debts, March 2, 2016, Gary M. Kaplan and Thomas R. Phinney, Hot Topics in Insolvency Law: Alter Ego Claims, Elizabeth S. Fenton, Trends in Piercing the Corporate Veil, July 31, 2013.* These articles present statistical data on veil-piercing cases in the US, discuss the most common ways of disregarding the corporate form and imposing personal liability on shareholders for corporate debts, and the trends developed in the veil-piercing doctrine.

Some very important cases of the US and the RA courts have been presented and analyzed in conjunction with the relevant statutory norms in the field of corporate veil-piercing.

The exhaustive list of literature sources will be presented to your attention in the Bibliography section.

CHAPTER 1 - Piercing Corporate Veil v. Limited Liability

This Chapter encompasses a brief overview of historical development of Anglo-American law protecting business entities and establishment of principle of "limited liability". It, also, addresses the so-called "piercing the corporate veil" doctrine, as well as the advantages and shortcomings of both "limited liability" and "piercing the corporate veil" concepts for the business environment.

The Development of Law Protecting Business Entities: Principle of "Limited Liability"

A fundamental principle of Anglo-American law is that a business operating as a legally recognized entity is separate and distinct from its owners. Under current law, this principle is not limited to corporations but extends to limited liability companies and to limited partners in limited partnerships, etc.[5] The corporate form was created to allow shareholders to invest without incurring personal liability for the acts of the corporation.[6]

Consequently, the liability of an individual for the obligations of an entity is limited to his or her interest in the entity. This concept of limited liability has been called the most attractive feature of corporation.[7] Often, it is the primary reason for incorporation.

The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting their personal wealth to the risks of business.[8] This incentive to business investment has been called the most important legal development of the 19th century.

[5] Reference to corporations in this article will also include these other entities.
[6] Pearson v. Component Technology Corp., 247 F.3d 471, 484, 17 I.E.R. Cas. (BNA) 769, 143 Lab. Cas. (CCH) ¶11005 (3d Cir. 2001).
[7] Henn, Handbook of the Law of Corporations and Other Business Enterprises (2d ed.) § 96.
[8] Consumer's Co-op. of Walworth County v. Olsen, 142 Wis. 2d 465, 419 N.W.2d 211, 213 (1988).

Ordinarily, a corporation is regarded as a separate legal entity, separate and distinct from its shareholders, officers, and directors, with separate and distinct liabilities and obligations.[9] The separate status isolates the actions, profits, and debts of the entity and those who invest and/or run the entity.[10] A corporation is treated entirely separate from its shareholders even where one individual owns all of the stock.[11] This principle extends to tax liability where generally the revenue of an entity will be recognized as having a separate taxable identity unless it is shown to have no legitimate purpose either in its formation and subsequent existence or that it was a sham setup to avoid taxes.[12]

Corporation is considered to have a "legal personality" which refers to the general and abstract capacity of a certain entity to operate as a legal subject.[13] The corporation is such an autonomous legal subject.

Although the principle of limited liability is established law and virtually sacrosanct, it is relatively new, having gained recognition primarily during the past century.[14] The early corporations did not arise out of a desire for limited liability; their primary purpose was to facilitate a perpetual succession of individuals in a single enterprise. Limited liability on a broad scale did not develop until well into the 19th century, first by legal ingenuity, then by statute.[15]

Traditionally, a joint-stock company had the power to make calls on shareholders for money to pay its debts and creditors could derivatively assert this power directly against shareholders by a process resembling subrogation.[16] To prevent this, corporations began to expressly disavow or limit their power to make levies on shareholders. The result was a form of limited liability.

England first recognized limited liability by statute in 1855. Under the Limited Liability Act,[17] a company could obtain a certificate of registration “with limited liability” upon complying with the requirements of the Act as to registration and so forth. The company had to

[9] Sonora Diamond Corp. v. Superior Court, 83 Cal. App. 4th 523, 538, 99 Cal. Rptr. 2d 824 (5th Dist. 2000).
[10] In re Phillips, 139 P.3d 639, 643 (Colo. 2006).
[11] RDM Holdings, LTD v. Continental Plastics Co., 281 Mich. App. 678, 762 N.W.2d 529, 550 (2008).
[12] Morris v. New York State Dept. of Taxation and Finance, 82 N.Y.2d 135, 603 N.Y.S.2d 807, 813, 623 N.E.2d 1157 (1993).
[13] J.E. ANTUNES, Liability of corporate groups. Autonomy and control in parent-subsidiary relationships in US, German and EU law. An international and comparative perspective, Deventer/Boston, Kluwer Law and Taxation Publishers, 1994, 57.
[14] 1 Blackstone, Commentaries §§ 455 to 473.
[15] Neil A. Helfman**, Establishing Elements for Disregarding Corporate Entity and Piercing Entity’s Veil*, American Jurisprudence Proof of Facts 3d , June 2016 Update
[16] Henn, Handbook of the Law of Corporations and Other Business Enterprises (2d ed.) § 14.
[17] Limited Liability Act, 18 & 19 Vict. c. 133.

use “Limited” as the last word of its name and its members were not liable for any judgment against the company, except to the extent of their unpaid subscriptions.[18]

In their article "Limited Liability and the Corporation" (1985) Easterbrook and Fischel note that in the light of the availability of limited liability and the possibility for investors to diversify against the risk, business managers will be encouraged to venture into activities that they would otherwise not undertake. Society as a whole can benefit from the increased production as a result thereof.[19]

From the point of view of economic efficiency (i.e. profit maximization), limited liability should meet three goals. First, it should allocate risk to those most capable of bearing it. Second, it should result in optimal levels of risk taking. And third, it should reduce transaction and monitoring costs.[20] In this respect, although much of it is the subject of debate, economists generally see both benefits and disadvantages in limited liability. [21]

The main pro-limited liability argument is that it convinces passive investors that do not participate in management to invest where they would not do if they would be exposed to the risk of unlimited liability. It also permits large-scale enterprises, where shareholders would not be bearing the risks involved and where it would be impossible to involve the thousands of investors in management. [22] Further, limited liability is said to increase the number of investments and a diversification of portfolios, encouraging economically useful risk-taking that would be discouraged under unlimited liability.[23]

Further, limited liability promotes a free transfer of shares, in that shares trade at one price regardless of the identity of seller or purchaser, thus limiting the amount of investigation and negotiation needed on the part of the buyer. Limited liability is therefore considered to be indispensable for an organized securities market.[24] Besides, limited liability reduces agency and information costs.

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[18] Neil A. Helfman**, Establishing Elements for Disregarding Corporate Entity and Piercing Entity’s Veil*, American Jurisprudence Proof of Facts 3d , June 2016 Update

[19] Karen Vandekerckhove, Piercing corporate veil: A transnational Approach (KATHOLIEKE UNIVERSITEIT LEUVEN
RECHTSFACULTEIT), p. 6

[20] J. FREEDMAN, "Limited liability: large company theory and small firms", The Modern L. Rev. 2000, vol. 63, no. 3.

[21] Karen Vandekerckhove, Piercing corporate veil: A transnational Approach (KATHOLIEKE UNIVERSITEIT LEUVEN RECHTSFACULTEIT), p. 6

[22] H.G. MANNE, l.c. (Va. L. Rev. 1967), 262.

[23] F.H. EASTERBROOK and D.R. FISCHEL, l.c. (U. Chi. L. Rev. 1985), 96-97.

[24] F.H. EASTERBROOK and D.R. FISCHEL, l.c. (U. Chi. L. Rev. 1985), 92.

On the other hand, limited liability shifts the risk of failure from shareholders to creditors, creating potential moral hazard.[25] For instance, it is unfair for involuntary, in particular, tort creditors. Tort creditors are not in a position to contract around limited liability or to bargain for higher compensation. Similar to involuntary creditors, labor claimants suffer from limited liability, in that they do not have the ability to inform themselves, to diversify, and to absorb losses. In this respect, limited liability may excessively encourage risky investments[26] and discourage corporations to take appropriate risk-reduction measures.[27] Finally, it is generally agreed that in the event of fraudulent misrepresentation as to the identity or the financial condition of the entity involved in dealings with third parties, limited liability should be eliminated.[28] As a result, for the economists, piercing of the corporate veil may constitute an adequate correction of the rule of limited liability: in this view, it is an attempt by the courts "to balance the benefits of limited liability against its costs".[29] On the other hand, its interference a posteriori, once a wrong has been committed, and the uncertainty about the circumstances in which it will be used give rise to doubts as to its deterrent effect.[30]

Introduction to "Piercing the Corporate Veil" Doctrine

In spite of its relative youth, the principle of limited liability remains a dominant characteristic of Anglo-American corporate law. Accordingly, the general rule, first articulated in *U.S. v. Milwaukee Refrigerator Transit Co.*,[31] is that *a corporation will be looked upon as a legal entity until sufficient reason to the contrary appears.* Because limited liability holds such an esteemed place in American jurisprudence, courts have cautioned not to dispense with it lightly[32] and that a corporation's identity should be disregarded with "great caution and not precipitately."[33] The United States Supreme Court has even noted that *one-person corporations*

[25] J.M. LANDERS, l.c. (U. Chi. L. Rev. 1975), 589.
[26] F.H. EASTERBROOK and D.R. FISCHEL, *l.c.* (*U. Chi. L. Rev.* 1985), 103-107.
[27] A.R. HEITLAND, "Survival of products liability claims in asset acquisitions", *Bus. Law.* 1979, vol. 34, 489 e.s., esp. at 498.
[28] F.H. EASTERBROOK and D.R. FISCHEL, *l.c.* (*U. Chi. L. Rev.* 1985), 112.
[29] F.H. EASTERBROOK and D.R. FISCHEL, *o.c.* (*The economic structure of corporate law*), 55.
[30] J. FREEDMAN, *l.c.* (*The Modern L. Rev.* 2000), 342; J.W. CALLISON, "Rationalizing limited liability and veil piercing", *Bus. Lawyer* 2003, vol. 58, 1069.
[31] U.S. v. Milwaukee Refrigerator Transit Co., 142 F. 247, 1 A.F.T.R. (P-H) ¶131 (C.C.E.D. Wis. 1905).
[32] Consumer's Co-op. of Walworth County v. Olsen, 142 Wis. 2d 465, 419 N.W.2d 211, 214 (1988).
[33] Oceanics Schools, Inc. v. Barbour, 112 S.W.3d 135, 140 (Tenn. Ct. App. 2003).

are authorized by law and should not lightly be labeled a sham.[34] Courts have often opined that their power to pierce the corporate veil should be exercised reluctantly,[35] and only in "exceptional circumstances, because of the chilling effect it has on corporate risks.[36] However, they have also noted that ***corporate structure is not a shield for dominant shareholders to hide behind while defrauding or injuring creditors or conducting illegal operations.***[37]

The doctrine of piercing the corporate veil is the rare exception, applied in the case of fraud or certain other exceptional circumstances, and is usually determined on a case-by-case basis.[38]

Albeit the limited liability offered by legal entities serves important public policy goals, there are times when strict adherence to the doctrine would bring about inequitable results. In such cases, courts will invoke the equitable doctrine of piercing the corporate veil to disregard the separateness of the entity and hold the principals liable for the acts or obligations of the corporation.[39]

In piercing the corporate veil, the courts frequently employ terms such as "alter ego," "instrumentality," and "sham," but the use of such words in judicial opinions is of little help to the practitioner; such labels serve as shorthand for a conclusion but provide no guidance as to what factors were considered in reaching that conclusion.[40]

Although there is no uniform code that is used by state or federal courts to provide guidance in determining when an entity's liability protection should be disregarded, the elements and standards of proof are fairly consistent.

It is impossible to trace the piercing doctrine to a specific date, but as early as 1809, courts saw that strict adherence to the notion of corporations as distinct entities might sometimes cause difficulties. In *Bank of U.S. v. Deveaux*,[41] the bank, a corporation located in Philadelphia, filed an action against certain Georgia residents in the federal circuit court of Georgia. The lower court held that a corporation, being an artificial entity, could not be a citizen and dismissed the

[34] Nelson v. Adams USA, Inc., 529 U.S. 460, 120 S. Ct. 1579, 146 L. Ed. 2d 530, 54 U.S.P.Q.2d 1513, 46 Fed. R. Serv. 3d 1 (2000).
[35] Longhi v. Mazzoni, 914 N.E.2d 834 (Ind. Ct. App. 2009), transfer denied, (Mar. 11, 2010), p.3 (2009).
[36] Nash Plumbing, Inc. v. Shasco Wholesale Supply, Inc., 875 So. 2d 1077, 1082 (Miss. 2004).
[37] West v. Costen, 558 F. Supp. 564, 585 (W.D. Va. 1983).
[38] ibid.
[39] Neil A. Helfman**, Establishing Elements for Disregarding Corporate Entity and Piercing Entity's Veil*, American Jurisprudence Proof of Facts 3d , June 2016 Update
[40] ibid.
[41] Bank of U.S. v. Deveaux, 9 U.S. 61, 3 L. Ed. 38, 1809 WL 1665 (1809) (overruled in part by, Louisville, C. & C.R. Co. v. Letson, 43 U.S. 497, 2 How. 497, 11 L. Ed. 353, 1844 WL 5963 (1844)).

action for lack of jurisdiction.[42] On appeal, the Supreme Court unanimously agreed that corporations were not citizens but concluded that the dispute was actually between the bank's shareholders (allegedly citizens of Pennsylvania) and the defendants. In order to preserve the jurisdiction of the federal courts over corporations, the Supreme Court looked beyond the corporate entity "to the character of the individuals who compose the corporation."[43]

Early piercing cases typically involved some form of fraud. In *Booth v. Bunce*,[44] a financially troubled partnership had formed a corporation and transferred property to it. The plaintiff was a bona fide creditor of the partnership and the defendant a bona fide creditor of the corporation. The purpose of the action was to determine which party was entitled to certain property transferred to the corporation. The jury found that the corporation had been formed in bad faith for the main purpose of defrauding creditors of the partnership and the trial court entered judgment for the plaintiff. On appeal, the defendant argued the law could not disregard the existence of a properly organized corporation, but, relying on established equitable principles, the New York Court of Appeals rejected this argument.

Though not a Supreme Court case, one of the most important decisions in the evolution of the piercing doctrine is *U.S. v. Milwaukee Refrigerator Transit Co.*[45] In this oft-cited case, the government sought an injunction under the Elkins Act to prevent the giving and receiving of unlawful rebates. Prior to the Act, the defendant carriers had routinely paid rebates to the defendant brewing company. After passage of the Act, the brewing company established a separate transit company and contracted with it to make all beer shipments. The transit company, in turn, contracted with the carriers. The defendants demurred on the ground that no rebates had been paid to the shipper (the brewing company). The government argued the transit company was the "alter ego" of the shipping company. Noting that the brewing company owned and fully controlled the transit company, the court overruled the demurrers:

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[42] The Constitution limits the jurisdiction of federal courts, inter alia, "to controversies between citizens of different states." U.S. Const., Art. III, § 2.

[43] This holding was later repudiated. In Louisville, C. & C.R. Co. v. Letson, 43 U.S. 497, 2 How. 497, 11 L. Ed. 353, 1844 WL 5963 (1844), the Supreme Court held that a corporation was "deemed" to be a citizen of the state of incorporation for diversity purposes. The rules currently applicable in determining corporate citizenship for diversity purposes are codified at 28 U.S.C.A. § 1332.

[44] Booth v. Bunce, 33 N.Y. 139, 1865 WL 4017 (1865).

[45] U.S. v. Milwaukee Refrigerator Transit Co., 142 F. 247, 1 A.F.T.R. (P-H) ¶131 (C.C.E.D. Wis. 1905).

> *"If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."*

Corporate veil-piercing is a generic term, covering many different realities. There are many reasons why shareholders[46] may incur liability vis-à-vis third parties. They may commit torts or breach the agreements they have entered into, personally guarantee the good performance of the contractual obligations of the corporation, and induce the corporation into a breach of contract for their personal benefit. There are many jurisdictions where, in all these situations, shareholders may incur a personal liability, based upon a wrongful conduct on their part. Limited liability is not at stake; whether or not the shareholder enjoys limited liability, it may incur liability on the basis of existing (statutory) legal grounds that apply to it in the same way as these would apply to natural persons.[47] Many authors argue that when shareholders are held liable on the basis of such independent legal grounds, this should not be considered as piercing of the corporate veil.[48] Some authors refer to it as quasi-piercing.[49]

On the other hand, the study of the substantive law on corporate veil-piercing will show that very often the courts do not distinguish between a personal liability of shareholder on the basis of statutory rules and a liability based upon typical veil-piercing doctrines. In many situations, shareholders are held liable on the basis of judicial veil-piercing theories while the cases could have been solved by reference to existing rules of corporate or civil law. The courts arbitrarily revert to piercing theories in one case and to rules on tort in another case, although both cases present similar facts. In addition, problems that are solved by means of veil-piercing doctrines in some legal systems are dealt with by reference to tort rules in other legal systems.[50]

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[46] The term "shareholder" shall also include parent corporations.
[47] Karen Vandekerckhove, Piercing corporate veil: A transnational Approach (KATHOLIEKE UNIVERSITEIT LEUVEN
[48] ibid.
[49] P. VLAS, *Rechtspersonen*, Deventer, Kluwer, 2002, 150.
[50] Karen Vandekerckhove, Piercing corporate veil: A transnational Approach (KATHOLIEKE UNIVERSITEIT LEUVEN

When it comes to corporate veil-piercing, the academic literature is characterized by incoherencies, confusions, and inconsistencies regarding the doctrine's practical application. The courts decide on a case-by-case basis whether to pierce or not, and try to balance all the advantages and drawbacks involved. As a matter of fact, the grounds on which the veil must be pierced are not clearly articulated. Hence, we can infer that the decisions on corporate veil-piercing may be substantially subjective, based on court's inner conviction.

CHAPTER 2 - "Piercing the Corporate Veil" Doctrine: The US Perspective

Like in the other legal systems, corporations in the United States have a corporate personality separate from the personality of their shareholders. Only the corporation is liable for its obligations; a creditor of the corporation may look only to the corporate assets for recovery.[51] In the United States, these principles are known as the "entity law doctrine". Limited liability is considered a fundamental principle underlying the corporate system.[52]

Not infrequently, however, this general rule will give way, and the corporate form will be disregarded. The United States is probably the only country where some empirical data are available with reference to piercing of the corporate veil. As already mentioned above, a research conducted by Thompson studying approximately 1,583 cases on the piercing doctrine decided before 1985 showed that the corporate veil was pierced in nearly 40% of the reported cases. It further revealed no piercing of the corporate veil of a publicly held corporation (or more precisely, a corporation with more than nine shareholders); piercing only occurred in closely held corporations and corporate groups. According to the study carried out by Thompson, courts pierce the veil more often to get to an individual shareholder than to reach another corporation.

Reported Corporate Veil-Piercing Cases (decided before 1985)		
Contract Claims	Tort Claims	*Piercing was done more frequently in contract cases (42%) than in tort cases (31%).*[53]
779	226	

The conclusion that the courts are less willing to pierce the veil in tort cases also contrasts with the arguments of commentators that a tort setting makes for a much stronger case for veil-

[51] L.D. SOLOMON, D.E. SCHWARTZ, J.D. BAUMAN, E.J. WEISS, Corporations. Law and policy. Materials and problems, 3d ed., St. Paul, Minn., West Publishing Co., 1994, 328.
[52] Ph. I. BLUMBERG, o.c. (Substantive law), 106.
[53] R.B. THOMPSON, l.c. (Cornell L. Rev. 1991), 1036 e.s. Prof. Thompson updated his study eight years later: R.B. THOMPSON, "Piercing the veil within corporate groups: corporate shareholders as mere investors", Conn. J. Int'l L. 1999, vol. 13, 379.

piercing since the plaintiff had no opportunity to bargain for the lack of liability.[54] In 1999, Prof. Thompson expanded his data set to include cases through 1996. This generated another 2,200 cases to go with the initial 1,600. The results of the expanded study revealed not to be very different from those of the first study.[55]

The case law in this field is disparate and it is almost impossible to decipher a general trend. Many different definitions and tests have been proposed. Similar fact patterns give rise to contradictory results. For Blumberg, this is "one of the most unsatisfactory areas of the law, with hundreds of irreconcilable decisions and shifting rationales".[56]

Compared to the other legal systems, it seems more appropriate, with regard to the American legal system, to speak about "doctrines" rather than "grounds" or "bases" for piercing of the corporate veil. American legal writers usually distinguish between three principal doctrines in piercing the corporate veil: ***the instrumentality doctrine, the alter ego doctrine and the identity doctrine.*** In spite of different formulations, these doctrines are essentially the same. They are often considered to be interchangeable.[57] Besides these three main doctrines, other "grounds" for shareholder liability may also be found in the law of tort, and in rules on directors' liability.

Some general "factors" for corporate veil-piercing are excessive control/lack of separate existence (e.g., subsidiary is excessively dominated and controlled by parent corporation), inequitable conduct,[58] and "misuse of the corporate privilege". Some just and reasonable limitations on the exercise of limited liability can be imposed under particular circumstances in view of its proper use and functions. For instance, courts may pierce the corporate veil and hold shareholders personally liable for the debts of the corporation when the shareholders have misused the corporate privilege, and the corporation was a mere instrumentality or alter ego of its shareholders.[59]

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[54] F.H. EASTERBROOK and D.R. FISCHEL, l.c. (U. Chi. L. Rev. 1985), 112; C.S. KRENDL and J.R. KRENDL, l.c. (Den. L.J. 1978), 34; J.M. LANDERS, l.c. (U. Chi. L. Rev. 1975), 623.
[55] Thompson, Piercing the Corporate Veil: An Empirical Study, 76 Cornell L. Rev. 1036 (1991).
[56] Ph. I. BLUMBERG, l.c. (Hastings Int'l & Comp. L. Rev. 2001), 307.
[57] Ph. I. BLUMBERG, o.c. (Substantive law), 111.
[58] In addition to excessive control and lack of separate existence, most courts require that the parent corporation has engaged in fraudulent or illegal activities or otherwise in a conduct "akin to fraud", involving "fundamental unfairness", "inequity", "injustice", "moral culpability" or "bad faith".
[59] In re Medical Management Group, LLC, 534 B.R. 646, 61 Bankr. Ct. Dec. (CRR) 100 (Bankr. D. S.C. 2015).

These general "factors" appear to be preconditions for a successful veil-piercing case. Nevertheless, while excessive control is required in almost all veil-piercing cases, there are cases where personal liability was imposed in the absence of proof of inequitable conduct.[60]

Tests for Corporate Veil-Piercing

The "instrumentality" doctrine: A famous test for deciding veil-piercing problems was developed by Powell in 1931. It has been adopted in a famous New York decision - *Lowendahl v. Baltimore*,[61] and is widely applied, although in many variations, in different states.

In Powell's test, the three conditions for liability are (i) an excessive exercise of control; (ii) some wrongful or inequitable conduct; and (iii) a causal relationship between the plaintiff's loss and the shareholder's conduct.[62]

As to the first requirement, excessive control does not necessarily depend on partial or complete stock ownership; there must be a *de facto extreme intrusion in the corporation's day-to-day decision-making process*. Such control must further have been abused for *fraud or any other unlawful or unjust action*. Finally, *the plaintiff must have suffered a material loss due to the shareholder's action.*[63]

Even in those jurisdictions that will pierce an entity's veil upon a showing of instrumentality alone, it is still advisable to show misuse of the entity's legal status and limited liability to the claimant's detriment in order to invoke the court's equitable jurisdiction.

Under Florida law, for instance, in order to pierce the corporate veil, a plaintiff must allege that (i) the shareholder dominated and controlled the corporation to such an extent that the corporation's independent existence was, in fact, non-existent and the shareholders were, in fact, alter egos of the corporation; (ii) the corporate form must have been used fraudulently or for an improper purpose; and (iii) the fraudulent or improper use of the corporate form caused injury to the claimant.[64]

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[60] However, the majority view appears to be that even if unity of interest has been established, an entity will not be disregarded absent evidence that injustice would result if the acts in question are treated as the entity's alone.

[61] Lowendahl v. Baltimore & Ohio R.R., 247 A.D. 144, at 154; 287 N.Y.S. 62, at 73, aff'd 272 N.Y. 360; 6 N.E.2d 56 (1936).

[62] F. POWELL, o.c.

[63] Karen Vandekerckhove, Piercing corporate veil: A transnational Approach (KATHOLIEKE UNIVERSITEIT LEUVEN

[64] Solnes v. Wallis & Wallis, P.A., 15 F. Supp. 3d 1258 (S.D. Fla. 2014) (applying Florida law).

Additionally, when a person or entity "so dominates and controls another as to make that other simply an instrumentality or an adjunct to it, the courts will look beyond the legal fiction of distinct corporate existence."[65]

<u>The "alter ego" doctrine:</u> In another case, the court held that *"there is such a unity of interest and ownership between the corporation and the individual or organization controlling it that their separate personalities no longer exist, and failure to disregard the corporate entity would sanction a fraud or promote injustice."*[66]

The alter ego doctrine has been developed principally by the California courts, but is now widely used in all American states. According to this doctrine, when it comes to parent-subsidiary relationship, piercing of the corporate veil is proper when (i) such unity of ownership and interest exists that the two affiliated corporations have ceased to be separate and the subsidiary has been relegated to the status of the "alter ego" of the parent; and (ii) where recognition of them as separate entities would sanction fraud or lead to an inequitable result.[67] Sometimes a third condition is added, being control by the parent over the subsidiary; others consider that control is included in the "unity of ownership and interest" factor.[68] For Blumberg, the alter ego doctrine is closely related to the instrumentality theory and utilization of one test or the other does not appear to lead to a difference in the result.[69]

<u>The identity doctrine:</u> A final variant of the traditional veil-piercing theories in the United States is the identity doctrine. It was also proposed by Powell. Although it is still used as a theory different from the instrumentality and alter ego doctrines, it seems to be encompassed by the wording of these, particularly of the alter ego doctrine:

> *"If plaintiff can show that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would serve only to defeat justice and equity by*

[65] Gatecliff v. Great Republic Life Ins. Co., 170 Ariz. 34, 37, 821 P.2d 725, 728 (1991).
[66] Folger v. Cottle (Cal. App. 2002).
[67] Ph. I. BLUMBERG, o.c. (Substantive law), 118.
[68] E.g. Ph. I. BLUMBERG, o.c. (Substantive law), 119.
[69] Ph. I. BLUMBERG, o.c. (Substantive law), 120. This was affirmed by the Court of Appeals for the Second Circuit, stating: "Professor Blumberg believes – and we agree – that the three-factor rule in New York and the alter ego theory sued on in this case are indistinguishable, do not lead to different results, and should be treated as interchangeable" (Wm. Passalacqua Bldrs., Inc. v. Resnick Devs. S., Inc., 933 F.2d 131, at 138 (2d Cir. 1991)).

permitting the economic entity to escape liability arising out of an operation of one corporation for the benefit of the whole enterprise".[70]

In the US judicial practice the instrumentality, the alter ego and the identity doctrines are used interchangeably, notwithstanding different formulations in the legal literature.

"Piercing the Corporate Veil" Doctrine in Light of Current Legal and Economic Developments

Establishing elements for disregarding an entity's veil: Factors of consideration: In determining whether to pierce the corporate veil, the US courts will consider whether there was:

1. majority ownership and pervasive control of the affairs of the corporation,
2. thin capitalization,
3. nonobservance of corporate formalities or absence of corporate records,
4. non-payment of dividends,
5. nonfunctioning of officers and directors,
6. insolvency of the corporation at the time of the litigated transaction,
7. siphoning of corporate funds or intermingling of corporate and personal funds by the dominant shareholder(s),
8. use of the corporation for transactions of the dominant shareholder(s),
9. use of the corporation in promoting fraud,
10. ownership of the entity by one person or one family,[71]
11. the use of the same address for the individual and entity,
12. concealment of the entity's ownership,
13. attempts to segregate liabilities to the corporation,[72]
14. use of the entity as a subterfuge in an illegal transaction,

[70] Zaist v. Olson, 154 Onn. 563, 227 A.2d 552 (1962).
[71] Ownership of the entity by one person or family is just a factor for consideration. Taken separately, it cannot be a distinct legal ground for disregarding corporate form, in that the law allows establishment of an enterprise with one person ownership. The United States Supreme Court has noted that one-person corporations are authorized by law and should not lightly be labeled a sham (Nelson v. Adams USA, Inc., 529 U.S. 460, 120 S. Ct. 1579, 146 L. Ed. 2d 530, 54 U.S.P.Q.2d 1513, 46 Fed. R. Serv. 3d 1 (2000)).
[72] Mid-Century Ins. Co. v. Gardner, 9 Cal. App. 4th 1205, 1213, 11 Cal. Rptr. 2d 918 (3d Dist. 1992).

15. formation and use of entity to transfer to it the existing liability of another person or entity, and
16. the failure to maintain arm's length relationship between related entities, etc.

Taking into consideration the complexity of today's legal and economic reality, no single factor is dispositive in determining the two necessary elements for piercing the corporate veil under an alter ego theory- [73] instrumentality, and injustice. Some factors such as undercapitalization should serve as evidence of both of lack of independent existence and use of the entity to achieve an inequitable result. Undercapitalization is considered as one of the decisive factors in determining the alter ego or instrumentality element of the piercing test. However, courts have cautioned about relying too heavily in isolation on the factors of inadequate capitalization or concentration of ownership and control.

To establish an alter ego theory and to pierce the corporate veil in Arizona, the proponent of the theory must establish (1) unity of control and (2) that observance of corporate form would sanction a fraud or promote injustice.[74]

A. Unity of Control

Unity of control exists when a parent corporation or individual exercises "substantially total control over the management and activities" of the entity.[75] Courts look to numerous factors to determine whether the individuality or separateness of the entity has ceased to exist. Some factors which may be considered include: common ownership, common office space, financing of the entity by the parent corporation or individual, intermingling of funds, payment of salaries and other expenses of the entity by the parent or individual, failure of the entity to maintain formalities of separate corporate existence, and the plaintiff's lack of knowledge of the entities separate corporate existence.[76]

B. Observance of Corporate Form Would Promote Fraud or Injustice

In addition to establishing "unity of control," a plaintiff must also demonstrate that fraud or injustice will result if the veil is not pierced. While one consideration is whether the entity was formed to perpetrate a fraud or is being used for fraudulent purposes, this is not the only way to

[73] Meshel v. Ohev Sholom Talmud Torah, 869 A.2d 343 (D.C. 2005).
[74] Pimal Property, Inc. v. Capital Ins. Group, Inc., 2012 U.S. Dist. LEXIS 24172 (D. Ariz. February 27, 2012).
[75] Gatecliff, 170 Ariz. at 37, 821 P.2d at 728.
[76] Dietel v. Day, 492 P.2d 455.

establish injustice or inequity.[77] Accordingly, the totality of the circumstances must demonstrate an "overall element of injustice or unfairness."[78]

In summary, courts will disregard the corporate form "cautiously" because, otherwise, this would defeat one of the central rationales of incorporation. Nevertheless, veil-piercing can take place to hold individual shareholders or parent corporations personally liable when there is such unity of control/interest that separate personality of corporation ceases to exist and an inequitable result will follow, if the culpable acts are treated as those of the corporation alone. [79]

Although there is no codification of the veil-piercing rules used by the US state or federal courts in determining when an entity's liability protection should be disregarded, the elements and standards of piercing test are fairly consistent despite confusing terminology that often fails to make the distinction between alter ego element and the ultimate right to pierce the corporate veil. [80]

[77] Robert D. Mitchell, "Alter Ego Doctrine and Piercing the Corporate Veil".
[78] NetsJets Aviation, Inc., 537 F.3d at 176.
[79] Mesler, 39 Cal. 3d at 300.
[80] Neil A. Helfman**, Establishing Elements for Disregarding Corporate Entity and Piercing Entity's Veil*, American Jurisprudence Proof of Facts 3d , June 2016 Update

CHAPTER 3 - "Piercing the Corporate Veil" in the Republic of Armenia: A Comparative Analysis in Light of the US Approach

Veil-piercing doctrines, strictly speaking, often become relevant where the statutory rules fall short. Some jurisdictions clearly define substantive rules on shareholder liability and develop theories on abuse of the legal personality. However, there are jurisdictions where veil-piercing is highly fact-based process requiring consideration of the totality of the circumstances. In the RA the corporate veil can be pierced to the extent the shareholders are made liable by the law.

This Chapter tries to address the applicability of "piercing the corporate veil" doctrine in the RA, and draw parallels between the RA and the US legal cultures in disregarding the corporate form. The objective is to reveal gaps of Armenian legislation hindering application of existing veil-piercing rules and development of their scope.

Also, specific policy objectives are discussed in order to answer the question whether to pierce or not to pierce the corporate veil in the RA. Some major problems are considered that impede the RA Courts to disregard the existence of corporate entity outside intentional/purposeful bankruptcy context.

Armenia is considered to be in its transitional phase of legal and economic development. Obviously, business and corporate cultures are also in transition. The State prioritizes regulation of corporate affairs and shareholder liability, in that one of the most important prerequisites of business development is contributions made by shareholders. Thus, the rights of shareholders should be protected by law, which will encourage them to make investments. It is a matter of fact, that the RA legislation is protective enough when it comes to shareholders' rights. The same cannot be stated for creditors' protection, as you will see further.

The Legal Grounds for "Piercing the Corporate Veil" in the RA

This subtitle is dedicated to the analysis of the legal grounds on which the shareholders can be held liable for corporate debts in the RA.

The field of corporate veil-piercing is mainly regulated by *Article 3 of the RA "Law on Joint Stock Companies"* which reads as follows:

1. *A Company shall be liable for its obligations with all the property it owns.*
2. *A Company shall not be liable for the obligations of its shareholders.*
3. *The shareholders of a Company shall not be liable for the Company's obligations; the shareholders shall bear the risk of damage associated with Company activities to the extent of the value of their shares.*
4. *If the reason for Company insolvency (bankruptcy) is the activities (inaction) of shareholders or other persons that have either the right to give compelling instructions to the Company or an opportunity to determine the activities of the Company in advance, then these shareholders or other persons may be exposed to additional/subsidiary liability for the Company's obligations in an amount that cannot be covered sufficiently by the Company's property.*

   The activities (inaction) of shareholders or other persons are deemed causes to Company insolvency (bankruptcy) only if they used their rights or opportunities to compel the Company to carry out or refrain from carrying out certain activities, ***knowing in advance that it would lead the Company to a state of insolvency (bankruptcy).***[81].

We may infer from the wording of the above article that shareholders' "limited liability" is a general rule under the law. However, the 4th paragraph of the article states that shareholders[82] may be held liable for company's obligations, if their activities (inaction) caused company's insolvency (bankruptcy). In addition, shareholders' activities (inaction) are deemed causes of company insolvency only if the shareholders **knew in advance** that those activities (inaction) would lead the company to a state of insolvency (bankruptcy).

[81] RA Law "On Joint Stock Companies" HO-232. Adopted 25.09.2001.

[82] For ease of reference, the term "shareholder" will be used throughout Chapter 3 to also define "other persons that have either the right to give compelling instructions to the Company or an opportunity to determine the activities of the Company in advance."

This article provides shareholders with a very strong protection, in that the phrase "knowing in advance" envisages an intent on the part of a shareholder to lead the company to the state of insolvency (bankruptcy). The scope of this article is very narrow, and it regulates shareholder liability only in intentional insolvency (bankruptcy) cases. My study of the RA Court judgments/decisions didn't reveal any case where corporate veil-piercing took place on this legal ground.

Article 193 of the RA Criminal Code prescribes that deliberate bankruptcy, i.e. deliberate creation of insolvency features or increasing the extent of such features ..., which caused large damage to the debtor (the company) or the creditors, is a criminal offense. Pursuant to the mentioned article, under certain circumstances, the court may impose criminal liability on shareholders, if it finds that their activities, which led the corporation to insolvency for *personal interest or the interests of other persons,* caused *large damage to the debtor or the creditors*.

Article 75 of the RA Civil Code regulates the parent company-subsidiary relationship and sets forth that:

(...)

*"3. The parent partnership or company, which has the right to give mandatory instructions to the subsidiary company, shall bear **<u>joint and several liability with the subsidiary company for the performance of transactions entered into in accordance with its instructions.</u>** The parent partnership or company shall be considered as having the right to give mandatory instructions to the subsidiary company when this right is provided for in the contract entered into with the subsidiary company.*

(...)

5. In case of bankruptcy of a subsidiary company by the fault of the parent partnership or company, the parent partnership or company shall bear subsidiary liability for its debts. Bankruptcy of a subsidiary company shall be considered as occurred by the fault of the parent partnership or company, <u>where it has occurred as a consequence of execution by the subsidiary company of mandatory instructions of the parent partnership or company"</u>.

Probably, this rule is the most pro-veil-piercing, in that here the law disregards the distinct legal "personhood" of the subsidiary and the parent partnership or company (having the right to give mandatory instructions to the subsidiary) and provides for joint and several liability for the performance of transactions entered into in accordance with its instructions. Additionally, the fault of the parent company for subsidiary's bankruptcy is established when the bankruptcy occurs as a consequence of execution of mandatory instructions of the parent company. The article does not require that the parent company new or could have known that its instructions would lead the subsidiary to a state of bankruptcy, as opposed to the requirements of Article 7 of the RA "Law on Joint Stock Companies" discussed below.

Article 7, Paragraph 4, and Paragraphs 6-7, of the RA "Law on Joint Stock Companies" supplements the rule prescribed by Article 75 of the RA Civil Code, and stipulates that:

(...)

*4. A parent company (or a parent partnership) that has the right to deliver compelling instructions to the subsidiary shall bear **joint and several liability** with the subsidiary for transactions carried out at its instruction.*

A parent company (or a parent partnership) is deemed to have the right to deliver compelling instructions to the subsidiary if this right is granted by an agreement between the companies or emanates in another way not forbidden by law.

(...)

*6. In case of subsidiary bankruptcy caused by the parent company (or the parent partnership), the latter shall bear **subsidiary liability** for its subsidiary's debt. Subsidiary bankruptcy shall be deemed to have been caused by the parent company (or the parent partnership) if such bankruptcy emanated out of carrying out the compelling instructions of the parent company (or the parent partnership).*

7. In cases stipulated by paragraphs 4-6 of this Article, the parent company (or the parent partnership) shall be subject to liability if it knew or could have known about the emanation of respective consequences.

This article sets forth a legal ground for veil-piercing of parent company (a legal person) by prescribing joint and several liability for transactions carried out at its instruction by its subsidiary company[83]. Also, the parent company bears subsidiary liability in case of causing the bankruptcy of its subsidiary. However, the liability of the parent company can be called for only if the parent company ***knew or could have known about the emanation of respective***

[83] Article 7, Para. 2, of the RA "Law on Joint Stock Companies"
"A company is considered a subsidiary if the other (parent) company or partnership has the opportunity of pre-determining the actions of the subsidiary either by means of its majority equity share, or under an agreement between the two companies, or in any other way not forbidden by law".

consequences. In contrast to Article 7, Paragraph 7, of the RA "Law on Joint Stock Companies", Article 75 of the RA Civil Code does not require that the parent company knew or could have known about the emanation of respective consequences for the veil-piercing to take place. So, we can notice a discrepancy between the aforementioned articles and this discrepancy should be addressed by the legislature to ensure consistency in corporate veil-piercing practice.

Article 7, Paragraph 2, of the RA "Law on Joint Stock Companies" also provides the definition of the dependent company. It states the following: *"A company shall be considered dependent on the other (parent) company or partnership if the latter (the dominant, participating) company or partnership has more than twenty percent of the voting shares of the dependent company."* Interestingly, the Law does not provide for any possibility of holding the parent company liable for the dependent company's transactions carried out at its instruction or for the dependent company's debts in case the latter's insolvency is caused by the parent. The term "dependent" already stands for the fact that the dependent company is dominated by the parent company. Thus, this differentiated approach with regard to parent company's liability for its subsidiary and its dependent company is not justified, in that the parent can use its powers to pre-determine the actions of the dependent company (for instance, if it has 55% of voting shares (more than 20%) of the dependent company) in the same way as it pre-determines the actions of its subsidiary.

The joint analysis of Articles 3, Paragraph 4, and Article 7 of the RA "Law on Joint Stock Companies" shows that, as a general rule, the shareholders' (both natural and legal person shareholders) liability is limited. However, liability (joint and several or subsidiary) of the parent company, prescribed by Article 7, for its subsidiary's corporate debt can be characterized as veil-piercing. As a matter of fact, legal person shareholders are less protected by law because Article 7 provides legal grounds for piercing not only in intentional bankruptcy cases caused by the parent company but also for the transactions carried out by the subsidiary at the parent's instruction.

Conversely, natural person shareholders can be held liable for corporate debts only in cases prescribed by Article 3 of the RA "Law on Joint Stock Companies", and Article 8 of the RA "Law on Bankruptcy", that is to say, if she caused the bankruptcy of the company intentionally.

Another ground for disregarding the corporate form is stipulated in *Article 8 of the RA "Law on Bankruptcy"*[84]. It reads as follows:

*"If the debtor has been declared bankrupt by the fault of the holder of the debtor's statutory (share, equity) capital or other persons, who may give binding instructions to the debtor or predetermine the latter's decisions, including the executive of the debtor (guiding the activities of the debtor by direct and indirect actions, etc. (**intentional bankruptcy**), the founders (participants) of the debtor-legal person or the given persons shall bear joint responsibility for the liabilities of the debtor, in case of insufficiency of the latter's property*[85]*".*

To pierce or not to pierce...?What are the major problems that impede Armenian Courts to disregard the corporate form outside intentional bankruptcy context?

What happens in scenarios, where there is no intent on the part of the shareholder to cause company's insolvency (bankruptcy), but the shareholder appears to be the "alter ego" of the company (owns all of its stock) and uses the company as a mere conduit for the transactions of his own business, or the sole owner (in a single shareholder corporation) depletes the corporate assets through loans and uses them for personal expenses causing damage to company's creditors?

The RA legislation remains silent when it comes to regulating the above-mentioned practical situations. So does the case law.

[84]RA Law "On Bankruptcy", HO-51-N. Adopted 25 .12.2006

[85]Decision of the Court of Cassation of the Republic of Armenia (ԾԴ/0743/02/12), July 18, 2014

"When a claim for compensation for damages is filed against the legal entity's director and Article 8 of the RA Law "On Bankruptcy" is invoked as legal ground for the claim, in all cases with such factual and legal circumstances, the courts should, first of all, clarify the following facts:

- *Whether there is any bankruptcy petition is filed against the corporate debtor?*
- *Whether the claim for compensation of damages against the legal entity's director is submitted within bankruptcy case?*
- *Whether the defendants are considered as "subjects" under Article 8 of the RA Law "On Bankruptcy"?*
- *Whether insufficiency of company's (debtor) assets is confirmed by the court's judgment in the bankruptcy proceedings?*

Moreover, the Cassation Court stated that the burden of proving the facts and the negative consequences thereof are borne by the plaintiff, in accordance with Article 48 (1) and (6) of the RA Civil Procedure Code.

The Cassation Court affirmed that unless the possibilities of recovery from the company's assets are exhausted, director's joint responsibility for the debtor company's obligations cannot be invoked.

Therefore, the absence of legal grounds applicable to the proposed scenarios hinders the development of corporate veil-piercing practice in the RA because the courts cannot rule on disregarding corporate form without providing the legal basis for their judgment[86].

According to the principle of legality (prescribed by Article 6 of the RA Constitution), *State and local self-government bodies and officials shall have the power to perform only such acts for which they are empowered by the Constitution or laws.*

Thus, the courts, being state bodies, are not empowered to disregard the corporate form, except for cases provided for by Article 3 and Article 7 of the RA "Law on Joint Stock Companies", Article 8 (Intentional bankruptcy) of the RA "Law on Bankruptcy", Article 193 of the RA Criminal Code (Deliberate bankruptcy) and Article 75 of the RA Civil Code. Otherwise, the principle of legality will be jeopardized.

Further, when piercing the corporate veil and holding individual shareholders liable for company's obligations, it is important to remember that the property rights of shareholders are at stake. Article 60, Paragraph 4, of the RA Constitution states that *no one shall be deprived of property, **<u>except by court procedure in cases stipulated by law</u>***. Put simply, shareholders can be held liable for corporate debts and consequently, be deprived of their property (cash, real estate, property rights, etc.) only by court procedure in cases stipulated by the law, i.e., in cases mentioned in the previous paragraph only.

It is evident that the lack of legal grounds (prescribed by the law) for corporate veil-piercing can result in absolute limited liability of shareholders in some situations, which is not always justifiable. Recent economic developments call for creditor protection, and a well-developed veil-piercing rules can provide an equitable solution to this problem. The main hardship is that in contrast to the US legal system, the RA courts render judicial acts only in cases and within the limits provided for by the Constitution and the laws of the RA.[87] The RA courts are not empowered to create "law" like their US counterparts. So, it's for the National Assembly to adopt laws regulating corporate veil-piercing. The outcome is - "No rule, no piercing".

[86] RA Civil Procedure Code Adopted 17.06.1998
Article 132 (Verdict content), Paragraph 1: "The motivation must indicate the circumstances clarified by the court, the evidence on which the conclusions of the court are based, the argumentation for the exclusion of this or that evidence, as well as, *those laws and other legal acts by which the court was governed when adopting the verdict.*"
[87] Article 22, Paragraph 1, RA Law on Legal Acts of the RA HO-320. Adopted 03.04.2002

Also, the lack of a well-developed veil-piercing doctrine causes practical problems leading to its inequitable and inconsistent application. A vivid example of doctrine's inconsistent application is the civil case EKD/0268/02/10[88], where the Cassation Court of the RA (hereinafter referred to as "the Court") examined the lawfulness of the claim regarding confiscation of tax payments imposed on the legal entity from the entity's director. The creditor, in this case, was the State - the Republic of Armenia (administrative legal relations). The legal grounds for the claim were Article 14, Paragraph 10, Article 17, Paragraph 1, and Article 1058, Paragraph 1, of the RA Civil Code - articles pertaining to compensation for damages caused. The Court stated that the debtor's unlawful action (inaction), damages, casual link between damages and unlawful action (inaction), and the debtor's fault should simultaneously be proved in order to claim compensation for damages.[89] In this case, the Court considered the non-fulfillment of legal entity's tax obligations as a damage caused to the State, and stated that the claim of compensation for damages (unpaid or partially paid taxes) can be filed (through civil proceedings) against the person having obligations to submit tax returns.

The Court emphasized that in cases where the claim of compensation for damages is filed against legal entity's director (or person having an obligation to submit tax returns), it is necessary to prove that the action (inaction) was performed by the latter.

The Court affirmed that Arthur Paytyan caused damage to the State failing to submit the tax returns, and the Prosecutor's Office was entitled to file a claim under the law (tort rules). At the same time, the Court forwarded the case for a new trial to assess, taking into account the Cassation Court's reasoning, whether the compensation for damages was already obtained from the legal entity.

We can infer from the analysis of the aforementioned case that the Court applied the tort rules to the given factual circumstances. Hence, the following questions can be raised:

What about the entity's separate legal personality? Can we consider this ruling as a one step forward to veil-piercing through tort rules? If yes, why this approach is not extended to creditors (e.g., natural and legal persons) in civil legal relations?

No privilege is prescribed for the State as a creditor. This can be evidenced by *Article 82 of the "Law on Bankruptcy"*, which provides for the ranking in satisfaction of unsecured claims.

[88] Decision of the Court of Cassation of the Republic of Armenia (EKD/0268/02/10), 2013

[89] See decision of the Court of Cassation of the RA, Natalya Hakobyan v. Vardan Hayrapetyan (HQD3/0016/02/08), 13.02.2009

Pursuant to Article 82, *claims of unsecured creditors, including liabilities incurred from tax obligations, other mandatory payments, administrative fines with respect to the State Budget and community budgets of the Republic of Armenia* are placed 7th in the ranking. The law itself sets forth the equality of the State and other creditors with unsecured claims. Moreover, the same Article states that claims of citizens, to whom the debtor bears responsibility for inflicting injury to the life or the health (tort victims) are placed the 2nd. As one can notice, there was no intent to give a preferred creditor status to the State by the legislature.

All the aforementioned questions can bring about legal uncertainty, inconsistent and discriminatory application of the tort and corporate veil-piercing rules. Consequently, the need for adoption of unequivocal and clear rules, tests and standards on disregarding corporate form is justified to somehow ensure a uniform judicial practice. However, if the Cassation Court's approach is to be applied (piercing through tort rules), it should also be applicable to other creditors. Simultaneously, excessive veil-piercing through tort rules can put at risk the limited liability principle.

Arguments for veil-piercing

Article 12 (Extent of exercise of civil rights) of the RA Civil Code stipulates:

1. Actions of citizens and legal persons exercised solely with the intention to cause damage to another person, as well as abuse of a right in other form shall not be permitted. (...)

2. In case of not maintaining the requirements provided for in point 1 of this Article, the court or the arbitration tribunal may refuse a person in respect of the protection of the right belonging thereto.

When a shareholder uses its limited liability with the objective of escaping its personal obligations, when the legal entity is solely used for satisfaction of shareholder's personal interests, it amounts to abuse of a right, as the aforementioned article implies. Moreover, it becomes obvious that the legal entity is a legal fiction.

Consequently, considering the factual circumstances of the case, the courts may disregard the corporate form and deprive the shareholder of its limited liability.

Pursuant to Article 3, Paragraph 1, of the RA Civil Code:

"Civil legislation is based on the principles of equality, autonomy of will, and property autonomy of the participants of relations regulated thereby, inviolability of ownership, freedom of contract, impermissibility of arbitrary interference by anyone in private affairs, ***necessity of unhindered exercise of civil rights, ensuring the reinstatement of violated rights****, and judicial protection thereof."*

When a shareholder appears to be the "alter ego" of the company and uses it as a mere conduit for transactions of his own business, or the sole owner (in a single shareholder corporation) depletes the corporate assets through loans and uses them for personal expenses causing damage to company's creditors, we can assert that not piercing the corporate veil will impede the reinstatement of the creditors violated rights ensured by the Civil Code.

Therefore, taking into account the fact that the law prohibits the abuse and, ensures unimpeded exercise of civil rights, the corporate veil should be pierced in the above-mentioned exceptional circumstances, without prejudice to the limited liability of shareholders of de facto existing legal entities.

This approach towards corporate veil-piercing will ensure the restoration of justice, and serve as a measure to prevent the abuse of creditors' rights.

As to "limited liability" companies, the RA "Law on Limited Liability Companies" states that its members are not subjected to personal liability. It appears from the logic of the law that the doctrine of piercing the corporate veil is not applicable to limited liability companies. Thus, the law itself creates artificial factors for giving preference to limited liability companies. It is difficult to find any logical and reasonable explanation as to why members of limited liability companies should not bear personal liability unlike the shareholders of corporations[90] in cases prescribed by the law. As a consequence, the rationale behind piercing the veil of a corporation should also apply to an LLC given the similar liability shields that are provided by corporations and LLCs to their respective owners.

To conclude, the analysis done showed that there is a need for a well-developed veil-piercing doctrine to eliminate misconduct shielded by limited liability, to ensure justice and uniform judicial practice, and to protect creditors in Armenia.

[90] The term "joint stock companies" is used in the RA Civil Code and in the RA Law "On Joint Stock Companies".

Additionally, if "piercing corporate veil" doctrine is not developed and applied according to the law, the limited liability will be abused causing inequitable results and shareholders may escape personal obligations making use of their limited liability shield.

Eventually, the significance of developing corporate veil-piercing doctrine in the RA is justified by economic, as well as by constitutional, legal and practical considerations.

CONCLUSION

Revolving around the questions "*To pierce or not to pierce...?" and "What are the major problems that impede the Armenian Courts to disregard the corporate form outside intentional bankruptcy context?*", the following main findings can be outlined:

The piercing of corporate veil is a complex issue in the RA, in that veil-piercing can violate constitutional rights of shareholders, as well as of other corporate constituencies. It is established that shareholders can be held liable for corporate debts and consequently, be deprived of their property only by court procedure in cases stipulated by law.

However, there are many practical case scenarios calling for veil-piercing that are not regulated by the law. As opposed to the US legal system, the RA Courts are not empowered to create law, that is to say, to prescribe legal grounds for corporate veil-piercing. Therefore, the absence of legal grounds applicable to those scenarios hinders the development of veil-piercing practice in the RA.

Complying with constitutional requirements, it is crucial to set forth clear and precise legal grounds for disregarding corporate form and to incorporate the veil-piercing doctrine (alter-ego or instrumentality theory) into RA legislation. When the legal grounds for veil-piercing are prescribed, it is for the Cassation Court to develop standards and tests for piercing the corporate veil. The extensive US case law can serve as a source for deciding which factors should be considered to ensure consistency and equity in the application of the doctrine.

Also, the lack of a well-developed veil-piercing doctrine causes problems leading to inequitable and inconsistent judicial practice. In the civil case EKD/0268/02/10, the Cassation Court held that the tort rules can be applied to claim compensation for damages (unpaid or partially paid taxes) caused to the State by the legal entity's director who failed to submit the required tax returns. This decision raised many important questions as to the possibility of veil-piercing through tort rules. Consequently, the need for adoption of unequivocal and clear rules, tests, and standards on disregarding corporate form is justified to somehow ensure a uniform judicial practice. However, if the Cassation Court's approach is to be applied (piercing through tort rules), it should also be extended to other creditors, such as natural and legal persons.

Also, the definition of "piercing the corporate veil" should be provided for by the RA Civil Code. It will help shareholders, creditors, as well as the courts, perceive the notion of this doctrine correctly. Hence, all the stakeholders will have the same understanding of the phenomenon.

Undoubtedly, the piercing of corporate veil is an exception from the general rule of limited liability. Nevertheless, piercing becomes essential if the limited liability principle is used to cause damage to creditors' rights and legitimate interests.

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