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Piercing of the Corporate Veil in Armenia

Are the existing regulatory features of corporate veil piercing sufficient to tackle certain corporate misdeeds committed in the Republic of Armenia?

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ABSTRACT

Piercing the corporate veil is the practice of disregarding the limited liability characteristic of a corporation in order to make its shareholders, either individuals or parent entities, bear personal liability for the corporation's liabilities. In determining whether to apply corporate veil piercing, courts in many states such as the UK, Germany and also across the United States employ the theories of *Instrumentality* and *Alter ego*. In contrast, the Armenian regulation entails some elements and features of corporate veil-piercing, nevertheless, the practice of the courts with respect to the veil-piercing has been, in essence, avoided.

Even though the trait of limited liability has shown to be an essential device that enables the entrepreneurs and investors to freely take risks behind the 'veils' of the legal entities meanwhile bringing economic development to its shareholders and the state, there are very often reasonable excuses for the courts to disregard that trait. Such reasons for the disregard of the limited liability shall particularly come into effect when the companies are exploited as a sham to avoid business debts or not to extend liabilities to the shareholders. In this regard, the legislative body of the given state should undertake the adoption of relevant laws that are sufficient to tackle such corporate misdeeds whereas the judicial body should enforce unconstrained decisions that aim to protect the rights of those who are affected by such misdeeds.

This paper will define the corporations as well as observe the characteristics of corporations that are most closely connected to the doctrine and practice of veil-piercing. In the framework of the research, we will discuss the doctrine of corporate veil piercing and its application theories with the main focus on the U.S practice. Following the discussion of peculiarities of piercing of the corporate veil, a thorough analysis as regards to the doctrine will be conducted within the Armenian legal reality.

More specifically, it will be shown that the existing regulatory features adopted by the legislator do not provide 1) the judicial body with necessary instruments to lift the corporate veil in number of cases and, 2) hence, they do not adequately protect those who are affected by the corporate misdeeds. The paper will later demonstrate that the Armenian regulations with respect to veil-piercing should be amended by the use of many practices and theories that the international practice offers.

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LIST OF ABBREVIATIONS

RA – Republic of Armenia

SP – Sole Proprietorship

LLC – Limited Liability Company

JSC – Joint-Stock Company

LLP – Limited Liability Partnership

ECtHR – European Court of the Human Rights

SRC - State Revenue Committee of the Republic of Armenia

CC – Court of Cassation of the Republic of Armenia

INTRODUCTION

Imagine owning a small bakery shop in your town, which carries out its business activities under the form of sole proprietorship. Your business goes really well in the first year of its activity until one day one of your customers posts a review on your Bakery Shop's Facebook page claiming that she got poisoned after eating your cake and that she had plans of suing your bakery shop to demand compensation for damages. In the end, the poisoned customer files a lawsuit against your Bakery Shop and wins the case in the first instance court. All your appeals to the higher instances result only with more expenses in the face of state and lawyer fees with no positive outcome.

You are on the verge of mental breakdown as you slowly start to understand that as ruled by the Courts the claimant shall receive compensation for the damages in the amount of 10,000$ and as a defendant you have no option other than compensating wholly. It all ends with you repaying the whole amount to the poisoned customer on the account of your bakery shops' incomes and after the sale of your personal assets such as your own car. You realize that choosing the form of sole proprietorship for your business was not the wisest choice since you were held personally liable for the obligations of the Bakery Shop. It is, indeed, not one of the most pleasant moments that one can experience but the personal risks would significantly decrease if a more appropriate form were chosen, a form which would restrict the claimant's demand only to the business assets of your bakery shop without the incurrence of personal liability.

For the efficiency of this paper we will narrow down the circle of business organization types only to corporations, limited liability companies and joint stock companies. In many corporate jurisdictions of different states, the corporations are identified or replaced with the wording joint stock companies. The two are practically analogous in their characterization, that is to say, they have the same characteristics such as the possession of legal personality and limited liability, yet they also have some minor distinctions.[1]

[1] Robert Penington, *How Modern Corporations Are Organized*, 3 Corp. Prac. Rev. 23 (1931), at 387

In fact, Dutch East Indian Company, which is considered as one of the first and biggest corporations to be founded, was characterized to have the features of both limited liability and joint stock companies with a permanent capital base. The Dutch East Indian Company is mostly known as a corporation and it was organized to be the first limited liability joint stock company in the history.[2] In the Armenian reality, the naming - joint stock company is the official version as provided by the Law on joint stock companies, however, the features are synonymous to the one of a corporation.[3] Therefore, the term corporation may often be referred to joint stock and/or limited liability companies and, the terminology specific to the relevant jurisdiction may be used in the paper if required to distinct those.

In his book *Sapiens: A brief history of Humankind*[4], Yuval Harari draws parallels between a human and a legal entity arguing that the latter is "just like you or me." He explains that the legal entity is able to open a bank account, pay taxes and even own different types of properties just the way humans can and perhaps the only fiction that distinguishes the two is that legal entity cannot be pointed at since it has no physicality. The author further on concludes that the legal entities have shown to be so similar and successful for the people is because of their trait of *limited liability*.

Since the origin of the principle of the limited liability lies back in the 15th century, many businesspersons and entrepreneurs have been provided with the liberty to freely carry out their business activities knowing that their financial liability will be restricted to the sum they invest and also assets that the legal entity acquires or possesses.

One of the advantages that the limited liability can offer is that if something goes wrong with the business activities of the company, the personal assets of the founding shareholders remain untouched. The shareholders may be able to borrow millions from the banks under the name of their company while simultaneously remaining personally not liable to its creditors. Arman Peugeot, the founder of the well-known French automobile production company, Peugeot, managed to establish the company in 1896 and most ironically Peugeot, the company, is still alive and well, whereas Peugeot, the Homo sapiens died in 1915[5].

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[2] Maurice Aymard. Dutch Capitalism and World Capitalism, *The American Historical Review*, vol. 89, no. 3, 1948, at 235

[3] HO-232 (Adopted: 25 September, 2001, Entry to force: 27 October 2001)> https://www.arlis.am/DocumentView.aspx?DocID=137792

[4] Harari, Yuval N., Sapiens: A Brief History of Humankind. New York: Harper, 2015, at 288-289.

[5] Id. at 233.

Amid the many features that the legal entities offer, the key reason for the businesspersons to move forward with that particular corporate form always remained the fact that despite all the debts that the company may have, they will not be held personally liable. Nevertheless, as the history unfolds, the legal entities do not always serve their actual purpose but rather are employed as a veil for the personal benefits of shareholders. Many shareholders began abusing the protection vested to them by the limited liability. As a result of such fraudulent wrongdoings of shareholders or else called *Corporate misdeeds* both the public and private sector suffer enormous losses.

Thus, in order to prevent and eliminate further corporate misdeeds, the courts commenced to deviate from the established practice and decided to hold the shareholders and/or owners of the legal entities personally liable for the business debts by way of disregarding the limited liability. Although such first practices fractured the principles and many established rules of limited liability, where normally the shareholders and/or officers would not be personally liable, the integration of the instrument of ignoring the limited liability feature was reasonable. This practice has been commonly referred to as *piercing the corporate veil*. The doctrine of piercing the corporate veil is used to describe the court's actions when the legal entity becomes disregarded and the feature of limited liability gets pierced when certain requirements are met[6].

The instrument of corporate veil-piercing usually serves as the last alternative for the creditors or tort victims to receive their entitlements and damages. It has become a common undesirable practice for the creditors to lend money to the legal entities who later are not able to fulfill their obligations due to certain *fraudulent purposes*. The reasons for not fulfilling the obligations before the creditors may be various with many of them being unjust and deceptive. That is why the courts of many states have initiated the practice of no longer separating the companies and their respective shareholders through the limited liability shield. This practice, in fact, opened the doors for the creditors to file lawsuits against the shareholders of the debtor companies who attempt to avoid financial liabilities by deceptive ways and to hold them directly perhaps with a greater possibility of getting compensation.

[6] William A. Klein, J. Mark Ramseyer & Stephen M. Bainbridge, Business associations: cases and materials on agency, partnerships, LLCs, and corporations, Foundation Press,10th edition, (2018), at 206.

Moreover, the state authorities were bestowed the power to file lawsuits against such fraudulent shareholders in order to prevent tax evasion or compensation to the state.

Having all that in mind, it becomes clearer why the doctrine of piercing the corporate veil is such an important legal tool not only for recovering the justice in the commercial law but also for the stability of the economy as a whole. If no relevant provisions are provided in the domestic legislation system, then many fraudulent shareholders will continue to benefit unjustly and the creditors or the states will suffer the consequences. There are many other corporate misdeeds that the shareholders may commit by the use of the legal entity as a veil for their actions such as bribery or the environment pollution, nevertheless, the list will be delineated mainly on the discussion of the protection of creditors and state.

The legal mechanisms with respect to the option of corporate veil piercing in case of corporate misdeeds are not adequately regulated or practiced in the Armenian reality. Instead of having a proper application rules of the doctrine, there are certain provisions envisaged in the Laws on LLCs, JSCs, Law on Bankruptcy as well as the Criminal Code of the RA. The only provisions that establish possibility for the limited liability principle to be disregarded are expressed in the cases of *false entrepreneurial activities* and *intentional bankruptcy*. The laws lack certainty and warranties for the courts to determine piercing the corporate veil if there are proper reasons. The paper will, hence, discuss the pros and cons of existing veil-piercing regulations and demonstrate what policies shall be introduced for better tackling of the corporate misdeeds in Armenia.

So as to achieve the aim of this paper number of methodological approaches will be used such as evaluative and comparative. The first chapter will define the concept of corporations and describe the essential characteristics of the latter. The second chapter will observe the doctrine of corporate veil-piercing, namely its historical perspective and international practices. The third chapter will discuss the existing regulations of veil-piercing when corporate misdeeds are committed. The last chapter assesses the effectiveness of available features of corporate veil piercing in Armenia followed by the conclusion/recommendation section where the all the research findings will be finalized and policy recommendations on the given issue will be presented. Based on the findings of the research, relevant recommendations will be presented. The research of this paper was conducted using academic works/articles, books, the domestic and international case-law, etc.

CHAPTER 1: THE CORPORATION AND ITS CHARACTERISTICS

'Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?'[7]

-Edward, First Baron Thurlow (1807)

§1 Origin of the Corporations

In the 21st century, corporations are the lifeblood of modern civilization. Their impact is felt in almost every activity of human endeavor: the way people live, work, travel and even die. The political process has often been guided and manipulated by corporations and it has come to the point when corporations have practically no boundaries. However, if the corporations are left unchecked, the latter have the potential of committing irreparable harm to the planet and its inhabitants. In order to understand what the modern corporation is today; it is imperative that we first understand the origins of where they came from.

The first corporations appeared in the early 16th century in Europe where the monarchs gave the corporations a specific public mission in exchange for the formal right to exist. The corporation was created in the early colonial era as a granted privilege extended to a group of investors typically to finance a trade mission. The establishment of a corporation served to the interest of investors and monarchs, yet, not granted to ordinary citizens. Two northern European trading companies, the English and Dutch East Indian Companies

[7] Coffee, John C. "'No Soul to Damn: No Body to Kick': An Unscandalized Inquiry into the Problem of Corporate Punishment." *Michigan Law Review*, vol. 79, no. 3, 1981, at 386. *JSTOR*, www.jstor.org/stable/1288201;

established in 1600 and 1602 respectively became the first corporation-colonial institutions trading with Asia over the next couple of centuries.[8]

The trading business eventually prospered and they touched higher levels than the ones existing before. Small groups of traders and merchants traveled from their homelands to other places and sold goods brought from the Middle East. It was not until the Industrial Revolution in the 18th century when Adam Smith brought the revolutionizing theory of *laissez faire* according to which the businessmen should have been able to pursue their own self-interest with a sort of control of their business activities. This theory led to a transitional moment for the people of Western civilization from being a 'permanent worker' of the government or affiliated bodies to having the freedom to establish either public or private legal entities independent of the governmental instructions[9].

People now are given the freedom to choose amid the available legal entity forms to carry out their business activities. The most common corporate forms of business organizations globally are Limited liability companies, Joint stock companies (these are often referred as corporations in many states, particularly, in common law legal systems) and business partnerships.[10] Lawyers and academics who cope with the law of business organizations regularly tend to minimize the difference between various forms of business organizations.

Throughout the history, a constant question has elevated if it was absolutely necessary to have the expanding list of corporations, partnerships, sole proprietorships and not replace them with a unified system that would entail all the essential attributes.[11] To answer that we shall stress that there are different types of businesses with different volumes. All such businesses want to establish a legal entity that is inherently most efficient for their particular business with no need to reinvent the wheel sometime after.[12] That is the reason why the businesspersons need to pay close attention to the particular features of each form and make both financially and legally efficient decisions.

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[8] William N. Goetzmann, "Corporations and Exploration", Revised ed., Princeton University Press, 2016, at 305. *JSTOR*, www.jstor.org/stable/j.ctvc77dzg.25

[9] Naggar, Tahany. "Adam Smith's Laissez Faire." *The American Economist*, vol. 21, no. 2, 1977, at 36

[10] Booth, Richard A. "Form and Function in Business Organizations." *The Business Lawyer*, vol. 58, no. 4, 2003, at 1435

[11] Davies, Paul L.: Gower's Principles of Modern Company Law (6th edition, Sweet & Maxwell, London), 1997, at 238.

[12] *Id.* at 1438

§2 Characteristics of the Corporations

When trying to define what corporations are, Philips observed that corporations are very much alike people not in the sense that they have flesh-and blood like human beings but with all the moral obligations and political rights they are bestowed.[13] They have certain rights and responsibilities that are comparable to the one that we, humans, possess but they are artificial beings, invisible and existing only in consideration of the law.[14] Human beings organize corporations for certain reasons but the major one amongst them has always remained the economic benefit. The corporations are formed by the mere law and they possess only the attributes which the law defines and the charter the latter's creation confers. [15]

The corporations as a rule have number of distinctive characteristics that altogether separate them from the other types of legal entities and help to obtain certain rights and obligations. Many specialists in the field of corporate/business law distinguish characteristics of corporations that overlap one with the other. In his book, *A theory of firm*, Jensen discusses the importance of corporations in the modern life and aims at signifying what the main traits of corporations are. According to him, the central attributes of the corporations are the legal personality, transferable stocks and shared ownership.[16] It is essential to note that Jensen identifies the weight of features rather for their economic importance than the legal one aspect.

Kraakman describes the corporations as entities that attribute key legal elements that are legal personality, delegated management under a board structure and limited liability. Some of the features as mentioned by Kraakman overlap with the features of different authors, however, the latter describes the corporations as entities that operate under the specific nexus of contracts for their essence of duality.[17] Nevertheless, for the purpose of this paper we will closely observe the characteristics[18] as proposed by Easterbrook and Fischel

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[13] Phillips, Michael J. "Corporate Moral Personhood and Three Conceptions of the Corporation." *Business Ethics Quarterly*, vol. 2, no. 4, 1992, at 440.
[14] Trustees of Dartmouth College v. Woodward, 17 U.S (Wheat), 1819, at 518
[15] *Id.* at 437
[16] Jensen, Michael C. A theory of the Firm – Governance, Residual Claims, and Organizational Forms (Harvard University Press). 2003, at 45
[17] Kraakman, Reinier, Davies, Paul, et al., The Anatomy of Corporate Law – A Comparative and Functional Approach (Oxford University Press, King's Lynn), (2004), at 36-37
[18] *These particular characteristics have also been selected for their significance in the Armenian reality

who state that the separating traits of corporation shall be the (i) *Perpetual existence*, (ii) *legal personality/identity* and (iii) *limited liability*.[19]

§2.1 Perpetual Existence

In most states it has become a conventional practice when the companies are incorporated without having a temporary existence limitation and only in exceptional cases do the founders/shareholders of the companies decide to have an ending date. If the shareholders decide, at the moment of registration, that the company should have a specified ending date, then the defined date shall be considered as an automated end of the corporation if prescribed in the charter of the company.[20] However, in the prevailing number of cases, the founders of the corporations do not specify an ending date, which means that the corporation can have an ending date only if a) the latter is declared bankrupt and then liquidated and/or b) the founders decide to liquidate the company accompanied by the court decision.

The characteristic of perpetual existence of the corporation gives the shareholders a sense of comfort meaning that the corporation is easy manageable, safer and a stable place to make investments, expect returns without having to worry about the sudden changes. Likewise, this characteristic eliminates any extra expenses the corporation may have taken for the regular updates/addendums in the state registration body. Alternatively, corporations are able to carry the information as initially prescribed in the charter without spending additional efforts to file any other documents.

Armenian regulation follows the international practice and pertains certain provisions in the law that consider perpetual existence of companies as a default rule. More specifically, in accordance with clause 5 of Article 8 of the Law on Limited Liability Companies of RA, "a Company shall be established without a time limitation, if otherwise is not stipulated by its charter".[21] Also, the legal status of joint stock companies with respect to the time limitations of the latter's existence is provided by Clause 4 of Article 2 of the Law on Joint Stock

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[19] Easterbrook, Frank H. and Fischel, Daniel R.: The Economic Structure of Corporate Law (Harvard University Press), (1996), at 11

[20] *Id.* at 178

[21] HO-252 (Adopted: 24 October 2001, entry to force: 21 November, 2001) > https://www.arlis.am/DocumentView.aspx?DocID=134784

companies of RA, where it is provided that "a company is deemed created without any time limitation, unless otherwise stipulated by the Charter of a company."[22]

§2.2 Legal personality/identity

A legal personality in case of companies is decided by the specific types of business organizations, which own separate property and assets (tangible, intangible) and the liability of the latter extends to the assets and investments it committed. The legal persons can acquire and exercise property and non-property rights, carry on responsibilities, act as plaintiffs and/or defendants in courts.[23] As Mark describes it, legal personality is the corpus of rights and obligations that authorize the legal actor to operate in a legal system. A legal actor may be a human being, an organized entity, or even an object. "Legal personalities need not all have the same content."[24] An analogical identification of legal personality has been directed by Bryant Smith who argued that the broad purpose of legal personality whether it is a human being, a ship or a molecule is to facilitate the regulation of human conduct and intercourse.[25]

To put it differently, legal personality should be regarded as a social and legal *property* of persons that consists of two traits: public and legal. The public trait of the legal personality is expressed in the fact that the legislator cannot choose the attributes of subjects of law arbitrarily, that is to say, they are dictated by the life itself, the needs and laws of social development. Whereas the legal trait is reflected in the fact that the signs of the subjects of law must be enshrined in the legal norms. It is, therefore, essential for the companies to have legal personality altogether with its trait to be able to act on their own and conclude contracts with different persons. When a company has a legal personality, it can transact and be sued separate from its owners.[26]

§2.3 Limited liability

Limited liability is a fundamental doctrine of corporate law. The rule of limited liability implies that the investors who make contributions to the equity capital of the company/corporation bear the risks only to the extent of the initial investments and the assets

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[22] S*upra note 3*

[23] Barseghyan T., Civil law of the Republic of Armenia, Yerevan State University publishing, vol. 1, 2014, at 85

[24] Gregory A. Mark, in International Encyclopedia of the Social 7 Behavioral Sciences, 2nd edition, 2015, at 192

[25] Bryant Smith, Legal Personality, Yale Law Journal, Vol. 37, No. 3, 1928, at 296

[26] Easterbrook, Frank H. and Fischel, Daniel R *supra* note 19, at 254

the company possesses.[27] The limited liability principle does not necessarily apply to all types of legal entities but is specifically restricted to Limited Liability and Joint Stock companies as well as Limited Liability Partnerships. Unlike sole proprietorships and other types of partnerships, the abovenamed are meant to exist separate from their shareholders which means they are regarded as separate legal entities. For example, if A and B persons, each owning 50% of the shares in the company they jointly organized, invested 200$ in total to the charter capital of the company, then each of them risks only 100$ and not more than the investment if no other assets are transferred under the property entitlement of the company.

When the limited liability is in place, the personal assets of the shareholders of the company are not available to creditors who initiate payment of the debt that is owned by the company. That said, the creditors can only reach the assets and investments that are possessed by the company, but not more. So, if company A, which has 1000$ investments in the charter equity and no business assets, has liability in the amount of 5,000$ towards Creditor B but has no financial capacity to repay the lent money, then Creditor B may reach only to 1000$ initially invested by the shareholders of company A. The personal assets of the shareholders of Company will remain unaffected due to the principle of limited liability.

The limited liability principle plays major impact in economic structuring too. If there were no laws, precedents amending limited liability, many investors would restrain themselves from opening companies or acquiring membership interests. The reason of the impact that the whole concept of limited liability results is that without the latter the creditors would be overpowered. Additionally, as Elderbrook states, many corporate features such as free transfer of shares or low cost of shareholder monitoring would be vague leaving the corporate world full of riddles.[28]

The principle of limited liability is guaranteed by the Armenian law. In particular, Article 5 of the RA Law on LLCs, envisages that "the participants in a Company shall not be liable for the obligations of the Company and shall bear the risk of losses related with the activity of the Company *within the value of their contributions*." It is also defined by the RA Law on LLCs that the company, on its turn, shall not be liable for the obligations of its participants.[29]

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[27] Id. at 255
[28] Id. at 94
[29] S*upra note 21*

Eventually, as time went on, the principle of limited liability was abused by the investors and shareholders of corporations to achieve fraudulent benefits. The rule, which constantly prevailed the shareholders high-level protection in terms of the division of their personal assets from those of their company's became not absolute.[30] Courts in common law systems started interpreting their decisions in line with the developments in the corporate world and the limited liability of corporations was occasionally overruled.[31] This practice of dismissing the limited liability originated in the UK in the late 19th century and gradually allowed the creditors as well as the state authorities to "pierce the corporate veil", that is to say, hold the shareholders of the corporation personally liable for their claims.[32]

CHAPTER 2: PIERCING OF THE CORPORATE VEIL

§1 Historical Perspective

The principle of the corporate veil-piercing initiated the establishment of the practice according to which the creditors of a corporation were allowed to reach the personal assets of the latter's shareholders in order to satisfy their claims. Furthermore, in number of precedential decisions of international courts, the disregard of the corporate veil was used to uncover the fraudulent and inequitable actions of corporations to avoid compensating their tort obligations, tax liabilities as well as any other liability that is imposed on them by the law. Even though it was previously mentioned that the limited liability rule regulated the separation of liabilities between the shareholders and the corporation, the legal developments in the corporate law required evasion of the rule in some exceptional cases such as the ones specified above.[33]

With the rise of similar cases where creditors lend money to a corporation, which end not fulfilling their obligations due to fraudulent purposes, the creditors started arguing that

[30] Callison, J. William. "Rationalizing Limited Liability and Veil Piercing." *The Business Lawyer*, vol. 58, no. 3, 2003, at 1065
[31] Easterbrook, Frank H. and Fischel, Daniel R, *supra* note 19, at 89
[32] Id.
[33] Wormser, I. Maurice. Piercing the Veil of Corporate Entity, *Columbia Law Review*, vol. 12, no. 6, 1912, at 503

the corporation's limited liability characterization should no longer separate the legal personality of the corporation and its shareholders. They started arguing that the shareholders as well as any persons who can directly instruct the corporations shall be equally liable with their personal assets for the satisfaction of their claims against the corporations due to their fraudulent motives/instructions.

In number of jurisdictions, the tax authorities came to the idea that many corporations were operated as *Special purpose vehicles* in order for the shareholders to avoid tax payments, in particular the income taxes[34]. Due to the growing number of cases where the corporations would avoid performing their tax obligations after concluding certain transactions, arguments have been made that the courts shall be vested the power to determine if any corporate misdeeds have been actually committed.

The road to the first applications of corporate veil-piercing internationally took a long period of time. Many states like the U.S (both in their federal and statutory interpretations of the laws) did not provide any possibilities for circumvention of the rule of limited liability where it would be specified that upon intervention of exceptional reasons the veils of the corporation may be pierced. Whereas, nearly in the whole period of the 20th century Armenia was a member state of the Soviet Union having no proper laws regulating the corporate relations.[35] It was not until the year 2001, when an independent Republic of Armenia adopted laws governing the relations of legal entities. Moreover, even after having a distinctive law dedicated to the imposition of the limited liability doctrine in the legal entities, the laws did not provide any possibilities for the veil-piercing principle to apply in exceptional cases.

However, in common law systems, the doctrine of piercing the corporate veil has been shaped by the court decisions regardless of the absence of the latter in the regulating laws. With the origin of the precedents availing the practice in the Unites States, merely between 1930 and 1985, there were about 2000 cases where the veil-piercing was employed and the early signs confirmed the theories that such practice will only increase in numbers, making it the most litigated legal issue in corporate law.[36] By the application of the piercing of the corporate veil principle in their precedential decisions, each state court developed the application criteria of their own. The Courts established not only the application criteria but

[34] McDowell & Co. Ltd v CTO, Supreme Court (1985)
[35] Berman, Harold J., The Comparison of Soviet and American Law, *Indiana Law Journal*, 1959, at 568
[36] Thompson, Robert B., infra note 52, at 1036

also the certain circumstances where it would be unreasonable to defend the principle of limited liability. Therefore, it is essential to understand the development of the doctrine of piercing of the corporate veil in different case laws of the states such as the U.S, U.K, Germany, and Russia. The main focus of the case law study will be maintained on the U.S practice considering the particular recognition of the doctrine and the number of precedents shaped there.

§2 U.S Case Law and Practice

The doctrine of piercing the corporate veil is a special legal decision that has been shaped in the US case law, however, it is applied only in exceptional cases with the aim to protect the rights, namely the interests of the public and the creditors. The courts in the US also allow the transfer of not only tort obligations from a legal entity to individuals, but also the transfer of contractual obligations in some cases[37]. As established by different court practices, there are certain "tests" that help a judge, taking into account all circumstances, solve the issue of the need to use the tool of piercing of the veil.[38] Ultimately, all the courts of each state have made differing decisions, yet the commonality between all of them seems to be in the presence of two essential components upon identification of which the courts consider the possibility of piercing. The components that are required for the application of the concept are *the control of the corporation by a direct instruction in connection with which the latter is used as a façade and/or an empty shell, as well as the improper purpose, that is, the corporation was formed to deceive and mislead and not fulfill legal obligations.*[39]

In many states, the courts use as commonly known the *instrumentality theory* or method to understand whether the piercing of the corporate veil is required or not.

The instrumentality theory implies that the criteria to be considered prior to piercing the corporate veil are mostly the following:

- "unity of interest and ownership";
- "wrongful conduct";
- "proximate cause".[40]

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[37] Wormser, *supra* note 33, at 507

[38] *Id.*at 508

[39] Hare, Christopher. From Salomon to Spiliada: Orthodoxy and Uncertainty in the Supreme Court, The *Cambridge Law Journal*, vol. 72, no. 2, 2013, at 287

[40] Rands, William J., Domination of a Subsidiary by a Parent, *Indiana Law Review*. 32, 1998. at 421

At least two of the above-mentioned criteria shall be in place in order for the courts to be able to disregard the veil. The first requirement deems that the unity of interest and ownership occurs when the separate personalities of the shareholder/parent company and the corporation no longer exist. According to the second criterion, a wrongful misconduct shall be undertaken by the corporation, that is to say, the corporate abused its powers in order to achieve fraudulent benefits. Finally, the last requirement provides that the members who have the power to instruct the corporation should have foreseen that the wrongful actions that are carried out by the latter will result in injustice to the creditors.[41]

In a similar decision ruled in *Perpetual Real Estate Services, Inc v Michaelson Properties Inc.*, the fourth circuit court stated that "the piercing shall not be performed merely based on the factor that a harm was caused to the creditor resulting in unfairness or injustice." [42] The court, in that account, found that no piercing shall be possible without the component of *corporate misdeed* that has been directed by the persons controlling the corporation in order to avoid the debts.

In *Belvedere* test, the Ohio Supreme Court enshrined a three-part test that must be met in the state of Ohio before a court may consider piercing the corporate veil.[43] Having that said, as stated by the Ohio Supreme Court "the corporate form may be disregarded and individual shareholders may be held liable for corporate misdeeds when:

- "Control over the corporation by those to be held liable was so complete that the corporation has no separate mind, will or existence of its own;
- Control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity;
- Injury or unjust loss resulted to the plaintiff."[44] (instrumentality theory in part).

The requirements as defined by the court identify the same essential reasons that were already illustrated in the previous case laws; however, the interpretations are quite different. Under the first requirement, the court refers to the factor of alter ego, that is to say, the persons who are considered to be held personally liable are the same persons who "have such

[41] Id. at 422
[42] Perpetual Real Estate Services, Inc. v. Michaelson Properties, Inc., 974 F.2d 545 (4th Cir. 1992).
[43] Belvedere Condo. v. R.E. Roark, 67 Ohio St. 3d (Ohio 1993)
[44] Bruce W. McClain, Piercing the Corporate Veil, 16 Ohio Law. 14, 2002

complete control over the corporation that it can be said to have "no separate mind, will or existence of its own."[45]

In regards to the second requirement of the test, it should be noted that the persons as specified under the first requirement must exercise their control "in a manner as to commit fraud or an illegal act" against the person seeking to disregard the corporate entity.[46] Nevertheless, the standards of fraud and/or an illegal act are defined in a precise and concrete manner, which, on its turn, makes it harder to digress from the regulation and, consequently, pierce the corporate veil. As a precondition for the application of the test, all the elements shall meet and this moderates the chances of the courts to pierce the corporate veil due to its high-standard nature.

The court attempts to provide a template for the lower instance that would be useful when determining whether to pierce the corporate veil or not by setting a high standard for the abuse of power by the persons controlling the legal entity. In other words, when analyzing the court's decision, it gets evident that the court attempted to make the test of piercing in a way as to require the debtor to be the person(s) who have the dominant powers in terms of overall control in the corporation. In addition, the court finds that the person(s) shall abuse the powers vested in them by way of making the corporation to commit fraud or an illegal act.[47]

There have been many cases when the corporations were undercapitalized and, consequently, not able to cover the debts having no purpose of acting as alter ego. In *Kinney Shoe Corp. v Polan*, the Court pierced the veil not for the reasons that the shareholders acted in a fraudulent manner resulting in the harm to the creditors, but for the reason that the shareholders used the shields of the subsidiary company to cover the debts of the parenting company.[48] Their actions resulted in the undercapitalization of the subsidiary company and, hence, were considered as another rule to the instrumentality theory.

In *re JNS Aviation LLC*, the bankruptcy court of the state of Texas discussed the cases where the veil of a corporation would be possible to pierce stating that "veil-piercing could be possible if any of the asserted strands are met."[49] In contrast to the Supreme Court decision

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[45] *Id.*
[46] *Id*.
[47] *Id.*
[48] "Kinney Shoe Corp. v. Polan, 939 F. 2d 209 (4th Cir. 1991)
[49] Nick Corp. v. JNS Aviation, Inc. (In re JNS Aviation, LLC), 350 B.R. 283 (2006)

made in Belvedere case, the Texas state bankruptcy court required only one of the strands/requirements to be in place for the legality of veil piercing. The strands as stated by the court require the corporation to commit an actual fraud and, the corporation, in this regard, shall be:

- The alter ego of its shareholders or the parent company(ies);
- The corporation is a sham to perpetrate a fraud;
- The corporation is used to avoid the legal obligation before other persons.[50]

Nevertheless, what is synonymous to the case of Belvedere is that the Texas court provided that the pierce of the corporate veil would be possible if there was an actual fraud perpetrated by the members of the corporation. The court in re JNS Aviation furthered its interpretation by also defining the criteria for what constitutes an actual fraud.[51] In other words, we can assert that the Texas state court also allocated essential weight to the doctrine of alter ego according to which the corporation has been used by the controlling members of the corporation as a façade or a sham for their personal benefit.[52] The theory of alter ego has interconnection with the occurrence of an actual fraud meaning that one cannot coexist when the other is not in place.

Last but not least, the piercing of corporate veil has not only been practiced by the U.S courts for the protection of the rights of creditors, but also the public and state interests. In particular, in number of case decisions the veils of corporations, which have been found to exist as the taxpayer's alter ego, were pierced to hold the shareholder(s) liable for the debts of corporation. In *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 351 (1977), the U.S Supreme Court held that "where the legal entity deems to be the taxpayer's alter ego, upon the failure to properly file tax returns and its fugitive status, it is appropriate to disregard the limited liability of the entity and consider all of its assets as the taxpayer's property for

[50] Legal Information institute of Cornel law school, Piercing the Corporate Veil, (March 31, 2020), https://www.law.cornell.edu/wex/piercing_the_corporate_veil

[51] Actual fraud is considered when all of the following strands are met: (a) a party conceals or fails to disclose a material fact within the knowledge of that party; (b) the party knows that the other party is ignorant of the fact and does not have an equal opportunity to discover the truth; (c) the party intends the other party to take some action by concealing or failing to disclose the fact; and (d) the other party suffers injury as a result of acting without knowledge of the undisclosed fact. *Id.*

[52] Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 Cornell L. Rev. 1036 (1991) Available at: http://scholarship.law.cornell.edu/clr/vol76/iss5/2

federal collection purposes.[53] Having that said, the doctrine of the corporate veil-piercing also serves purposes to prevent tax evasion of shareholders through the creation of alter ego.

Overall, the U.S case law and practice is based on the features of two main theories (instrumentality and alter ego) thanks to which it may be possible for the courts to pierce the corporate veil. A legal entity will be disregarded and the principle of limited liability ignored when: I) there is such unity of interest and ownership that the separate personalities of shareholders/parent companies and the corporation cease to exist; and II) the corporation is used as a sham/façade by the controllers of the corporation for the fraudulent purposes while causing harm to either the public or private sector.[54]

§ 3 International Case Law and Practice

The application or features of corporate veil-piercing have also been beheld in other international practices. To start with, the European Court of the Human Rights has referred to the doctrine of the piercing of the corporate veil when considering the admissibility of the claims made by the legal persons. The ECtHR stated that "[T]he piercing of the "corporate veil" or the disregarding of a company's legal personality will be justified only in exceptional circumstances, in particular where it is clearly established that it is impossible for the company to apply to the Convention institutions through the organs set up under its articles of incorporation or—in the event of liquidation—through its liquidators."[55]

The doctrine of corporate veil-piercing has been applied in the judicial decisions of the U.K courts on rare occasions. The disregard of the limited liability has been exercised mostly in the cases when the corporation goes insolvent and the creditors attempt to prove the corporate misdeeds of their debtors in the court to regain their money. In Caterpillar Financial Services v. Saenz Corp Limited, the Court exercised its discretion to pierce the veil finding that the company was 'an alter ego corporate vehicle of the defendant.'[56] With the court's decision to disregard the corporate veil, the personal assets of the guarantor of the transaction at issue were accessed by the creditor.

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[53] *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 351 (U.S Supreme Court, 1977)
[54] *Van Dorn Co v. Future Chemical and Oil Corp*., 753 F.2d 565 (7th Cir. 1985)
[55] *Agrotexim and Others v. Greece* judgment of 24 October 1995, Series A no. 330, at. 25-26, §§ 68-71
[56] *Caterpillar Financial Services (UK) Ltd v Saenz Corporation Limted and Others* ,EWHC 2888 (Comm) [2012]

The doctrine of the piercing of corporate veil as such is absent in the German laws. Nevertheless, there is the concept of "abuse of the law" shaped in the laws that plays a similar role in bringing the legal entities to account for their wrongdoings before the German courts. If the participants or shareholders of a legal entity use the corporate form in order to avoid liability and thereby harm creditors, citizens or the state, the German courts will consider depriving them of the privilege of limited liability.[57]

The provisions of the Russian legislation similar in meaning to the doctrine of corporate veil piercing are present only in situations where controlling persons are brought to subsidiary liability in case of bankruptcy of the debtor, as well as to joint and several liability of the parenting company for the subsidiary transactions. The piercing of corporate veil is used as an instrument to reduce abuse of rights and violation by the participants of companies in the practice of the Russian courts. However, the Russian courts are too conservative in tearing down the corporate covers, rather they prefer preserving the positivistic traditions and make decisions that are based on the *letter of the law*, yet not on the essence of the existing legal relations.[58]

To sum, despite the fact that the doctrine of piercing the corporate veil is not as developed and practiced internationally as, for example, in the U.S, all the above-mentioned states recognize that the principle of limited liability often serves as an instrument for all sorts of abuses and it is used to sanction for misdeed of the controlling members. The features of the doctrine are enshrined in different manners and the application is implemented by the means of different instruments. Eventually, one thing that is analogous in all the regulations is that all recognize the necessity of the legal instruments that would tackle the corporate misdeeds of the shareholders and the parenting companies.[59]

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[57] Hans Thummel, *Piercing the Corporate Veil - Germany, 6 Int'l Bus. Law. 282* (1978)., at 285

[58] Tikhon Podshivalov, Protection of Property Rights Based on the Doctrine of Piercing the Corporate Veil in the Russian Case Law, 6(2) Russian Law Journal, 39–72, (2018), at 156

[59] John P. Radnay, *Piercing the Corporate Veil under International Law*, Syracuse Law Review, (1965), at 785

CHAPTER 3: ARMENIAN REGULATIONS *re* THE PIERCE OF CORPORATE VEIL

It should be pointed out that no practice and, hence, no case law is currently available with respect to the doctrine of veil-piercing in the Armenian reality, thus, our research will be limited only to the statutory law. In order to examine all available cases that can be pertained in relation to the doctrine of the pierce of corporate veil, it is important to discuss the regulations regarding both limited liability and joint stock companies of the Republic of Armenia.[60] As provided by clause 3 of Article 5 of RA Law on LLCs, "*the participants in a Company shall not be liable for the obligations of the Company and shall bear the risk of losses related with the activity of the Company within the value of their contributions*."[61] What can be inferred from the above article is that the participants of the company and the company itself have shall separate personalities. The same statement can be made when looking at the relevant provisions of the Law on JSCs. In particular, it is defined that the shareholders shall be liable for the obligations of the Company and the liabilities of the latter extend to and are limited with the value of their shares.[62]

In contrast to the Law on LLC, clause 3 of Article 3 of the Law on JSCs alternatively states that "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*." [63] If we attempt to analyze the above-mentioned provision, we shall see that the legislator has intended to provide personal liability of the shareholders and/or other persons (who have the right to instruct the company in decision making process) if their malicious actions/inaction resulted in the insolvency or bankruptcy. The provision also adds that the personal liability of the shareholders and other persons towards the claims of the potential creditors extends to the degree of the value that has not been satisfied by the company assets.

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[60] We come to this idea based on the fact that in number of U.S cases, the creditors filed successful lawsuits against limited liability companies too.
[61] *Supra note 21*
[62] *Supra note 3*
[63] Id.

This generates the idea that the Armenian regulation with respect to the joint-stock companies has a feature that can be correlated with the doctrine of piercing the corporate veil since it waives the protection of the limited liability in cases when the company becomes insolvent or bankrupt based on the compelling instructions of the shareholders and other persons. However, we shall further our investigation in order to understand what regulations are enshrined under general norm as regards to the insolvency/bankruptcy proceedings.

The Law on Bankruptcy, in fact, does regulate the cases when the companies become insolvent or bankrupt by the deliberate instructions of shareholders or other persons. In specific, Article 8 of the Law on Bankruptcy envisages that "*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*."[64] Having that in mind, we should come to the conclusion that *if the debtor company has been declared bankrupt by the fault of the shareholder who gave intentional decisions to predetermine the bankruptcy of the company, then those shall bear joint liability before the creditors, if the property of the company does not satisfy the claims*.

Article 9 of the Law on Bankruptcy also provides the list of the persons who may be regarded as affiliated persons to the bankrupt company which, in a nutshell, are the subsidiary, parent companies; shareholders and executives of the company, as well as any other persons which may give binding instructions to the debtor or predetermine the latter's decisions.[65] The Law on Bankruptcy (Article 54(1)) further protects the rights of creditors as well as the public by granting the Administrator of the bankruptcy the right to apply for the recovery of any property, transactions that have been transferred or alienated to/by affiliated persons.[66] In the light of the above-mentioned article, we shall state that the legislator has also provided certain safeguarding provisions with respect to subsidiary liability in the Civil Code of RA. It is specifically prescribed under clause 2 of Article 415 that "where the principal

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[64] HO-51-N (adopted: 25 December 2006, entry into force: 22 January 2007)> https://www.arlis.am/DocumentView.aspx?DocID=121008

[65] *Id.*

[66] *Id.*

debtor has refused to satisfy the claim of the creditor, or the creditor has not received an answer to the claim submitted thereto within a reasonable term, *the concerned claim may be submitted to the person bearing subsidiary liability."*[67]

Thus, it becomes clear from the abovenamed regulations that in cases when the shareholders or any affiliated persons of the company attempt to ***intentionally*** predetermine the bankruptcy of the companies, they may bear personal liability towards the part of the claim that is unsatisfied by the company assets. These regulations safeguard the rights of the creditors who may be the victims of corporate misdeeds when intentional bankruptcy is predetermined by the binding decisions of shareholders or any other affiliated persons.

If the Administrator of the bankruptcy finds that there are reasonable doubts that the company may have been intentionally bankrupted, then the persons having such decision-making powers may become participants of both bankruptcy and criminal proceedings since the act of intentional bankruptcy is also criminalized. As provided by Article 159 of the Criminal Code of RA, "intentional creation of insolvency features by the founders (participants) of the debtor company or by other persons who had the opportunity to give compulsory instructions or to predetermine its decisions / ... / which caused ***large damage*** to the debtor or the creditors: is punished by imprisonment for the term of from two to six years, with deprivation of the right to hold certain public positions or engage in certain activities for up to three years."[68]

To sum, intentional bankruptcy is an instrument in the present Armenian laws that may allow the creditor to reach personal assets of the shareholder or the affiliated person to satisfy his claims. The intentional bankruptcy has been multiply used by the state authorities to file lawsuits against the shareholders of companies whose tax returns did not match the financial investigations of tax authorities. Nevertheless, there are certain limitations to the practice of this instrument which also leads to the scarcity of judicial practices in the Armenian reality as such where the court would regard the malicious actions/inactions of the controlling persons as intentionally bankrupting the company. Under the intentional bankruptcy the Armenian regulation acknowledges the bankruptcy is conditioned not by the

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[67] HO-239 (adopted: 05 May 1998, entry into force: 01 January 1999) >https://www.arlis.am/DocumentView.aspx?DocID=141434

[68] HO-528-N (adopted: 18 April 2003, entry into force: 01 August 2003)> https://www.arlis.am/DocumentView.aspx?DocID=142047

objective but by the subjective factors, that is, a person realizes that (i) *his actions create insolvency*, (ii) *wants to achieve the consequences for his own personal benefit* and (iii) *wants those benefits to cause harm to the company and the creditors*.

In addition to the provision providing liability for the controlling persons of a company when causing intentional bankruptcy, there is another regulation which prevents the use of companies as 'façades' or 'shams' by the shareholders to gain personal benefits. Article 189 of the Criminal Code of RA provides that "*establishment of a commercial enterprise without intention to conduct entrepreneurial or banking activity, aimed at obtaining loans, evading from taxes, obtaining other property benefits or hiding prohibited activities, which inflicted a large damage to the citizens, commercial enterprises or to the state, is punished with a fine in the amount of 300 to 500 minimal salaries, or with imprisonment for the term of up to 4 years and a with or without a fine in the amount of 50 minimal salaries*."[69]

In brief, the provision of ***fake entrepreneurial activity*** asserts that if there is no actual intention to conduct entrepreneurial or banking activity, that is to say use the company as a cover for transactions or other benefits, then the participants/shareholders of the company may be punished with a fine and even lead to imprisonment. However, according to clause 5 of the same provision, a person shall be released from criminal liability if he compensates for the damages, pays the calculated fines and penalties caused by the crime.[70] This provision safeguards rather the state interests than the interests of the private sector and citizens in general. The state revenue is vested the power to observe the financial reports of the companies which as informed by the Prosecutor General are suspected of structuring fake entrepreneurial activities. In fact, there are no instances of cases where this instrument has been successfully practiced in the Armenian reality.

Overall, there are certain regulations in Armenia, mainly in the Law of Bankruptcy and the Criminal Code of RA, which provide exceptions to the principle of limited liability. To be specific, the shareholders/participants of legal entities will bear personal liability and the veil will be pierced by the courts in two main exceptional cases. The first exception concerns the cases when the controlling persons of a corporation intentionally predetermine the bankruptcy of the latter which leads to (i) their personal gain and (ii) the damage of the

[69] Supra note 68
[70] Id

creditors and state. The controlling persons will bear joint liability before the creditors, if the property of the bankrupted company does not satisfy the claims.[71] Whereas, the second exception, as expressed under fake entrepreneurial activity, prevents the fraudulent cases where the shareholders of a legal entity establish the latter solely to utilize it as a cover to achieve personal benefits. The persons controlling such fake entrepreneurial activities bear criminal liability for their misdeeds.

CHAPTER 4: THE EFFECTIVENESS OF AVAILABLE FEATURES OF CORPORATE VEIL-PIERCING WHEN TACKLING CORPORATE MISDEEDS IN ARMENIA

§ Intentional Bankruptcy

Despite the fact that there are available legal instruments, namely the provisions of intentional bankruptcy and fake entrepreneurial activity, which aim at tackling the corporate misdeeds committed by the controlling persons of corporations in Armenia, there are reasons to believe that their effectiveness has not been adequate. The whole essence of the doctrine of veil-piercing is to adequately protect the rights of the creditors, citizens and the state from any types of corporate misdeeds that may be committed. Having that said, we need to understand the level of protection the above parties enjoy based on the existing features of corporate veil-piercing in Armenia.

Although it has already been established that no successful judiciary practice has been established with respect to veil-piercing, we need to point out that the Court of Cassation of RA has addressed the intentional bankruptcy in its precedential judgement stating that:

"…in the event of intentional bankruptcy, the entities mentioned in Article 8 of the RA Law on Bankruptcy, including the holder of the debtor legal entity, *may be jointly liable with the debtor's liabilities only if the debtor's property is insufficient to fulfill the liabilities*, *which, of course,* ***can only be disclosed as a result of the bankruptcy administrator's actions within the bankruptcy proceedings***."[72]

[71] In this sense, it is important to emphasize that the instrument of intentional bankruptcy is limited in its application within the scope of insolvency proceedings.

[72] Prosecutor General's Office v Artyom Gevorgyan, Court of Cassation of RA, 2012,< http://www.datalex.am/?app=AppCaseSearch&case_id=29554872554639718

Although the legislature has not clearly defined who can file a claim for joint liability under Article 8 of the Bankruptcy Law of RA, the CC interprets that such a claim can only be filed by the administrator of bankruptcy within the bankruptcy proceedings. By interpreting the law in that way, the CC has certainly put limitations with respect to the persons who can file a claim for joint liability if they believe the debtor company has intentionally gone bankrupted. In this sense, it is obvious that the creditors of the debtor company are deprived to exercise their right of filing a claim to the court even if they have sufficient evidences to think on the fraudulent intentions of the controlling persons of the debtor company. This limitation shaped by the CC is indeed problematic because many bankruptcy administrators may not find it necessary to file a claim to the bankruptcy court for the joint liability of shareholders when observing no elements of intentional bankruptcy and, thus, the creditors will have less chances to recover their damages.

Furthermore, there is also the issue of court jurisdictions when analyzing the availability of intentional bankruptcy both in the Law on Bankruptcy and the Criminal code of RA. Due to the lack of judiciary practice, it is unknown which court shall have the jurisdiction to examine the case if the Administrator in the bankruptcy proceedings files a claim to the Court of bankruptcy. Taking into account the fact that the rights of the creditors with respect to filing a claim on intentional bankruptcy have been restrained by the decision of the CC, the last resort for them would be reporting to the police. Yet, we need to state another problem related to the CC decision.

The issue is that when interpreting the given provision, the CC expressed that only one authority has the right to file a claim which makes us reason that the state will practically not be able to exercise any rights due to the fact that the General Prosecutor has no right to file a claim. As provided by the CC, the intentional bankruptcy shall be examined only within the bankruptcy proceedings by the relevant court, whereas, the act of intentional bankruptcy is criminalized in the Criminal Code of RA. Thus, the decision of the CC not only puzzles the jurisdictional dispute of the courts but also raises the issue of state interest protection.

Even though it has become common for many creditors to lend money to the companies after securing the transaction through collateral, bank/personal guarantee and other such methods, there are still many creditors who do not use a ‘back-up plan’ in case the debtor defaults on the loan.[73] In fact, majority of the loans in Armenia are lent to the debtors

[73] The default on the loan is quite often triggered by the insolvency/bankruptcy of the debtor,

in the amount of less than 1,000 U.S dollars without securing the transactions and that is why the numbers of unsatisfied claims within the prescribed amount is relevantly high.[74] Having that said, the regulations with regards to the group of creditors as specified above shall ensure high-level of protection in cases of voluntary/intentional bankruptcy too.[75]

However, the existing provisions fail to address those creditors due to the provision of the least amount of damage provided by the Criminal Code of RA. The relevant provision in the Code is extended only to the creditors whose debt amounts at least in *large damage*. The legislator hereby promulgates that the rights of only those creditors are protected whose debt exceeds the amount of 500,000 Armenian Drams (~1000$).[76] The prevailing number of cases represent the secondary creditors whose claims are lower than the number stipulated by the Code meaning that even in case the Administrator of bankruptcy applies to the court claiming that there are characteristics of intentional bankruptcy, there are no legal possibilities to protect the rights of the above-named creditors.

Last but not least, the wording that is used by the Law with respect to the intentional bankruptcy is too vague. It is not definite which corporate misdeeds need to be particularly understood within the context of the law. In addition, there might also be cases where the company is under-capitalized, meaning unable to satisfy the claims of the creditors, however, it is not clear whether that constitutes to have the features of intentional bankruptcy or not. These loopholes are not necessarily the issues that need to be addressed solely by the legislator. The existing regulations may be interpreted by the Armenian courts in a way to uncover the discussed issues and at the same time not to contradict the laws.

§ Fake entrepreneurial activity

Fake entrepreneurial activity is the second instrument which can be similar to the doctrine of corporate veil-piercing in some way. The features of this instrument may substitute the veil-piercing by its capability to prevent actual frauds and any other corporate misdeeds committed by the creation of 'sham' or 'façade' companies. In fact, in number of U.S court judgements such as in *Kinney Shoe Corp* and/or in *Van Dorn Co*, the courts found that the veils of the corporation will be disregarded if the legal personality of the entity is

[74] «ՀՀ Սեռնկությյան Ոլորտի Հետազոտության Հաշվետվություն», ՀՀ Արդարադատության Նախարարություն, 2018, at 87, Retrieved from: http://moj.am/storage/uploads/0AM02.pdf,
[75] Voluntary and intentional bankruptcy have been synonymously presented to emphasize their interconnection.
[76] Supra note 68

used as a sham/façade by the controllers of the corporation for the fraudulent purposes while causing harm to the creditors or the state.[77] In this regard, the Armenian regulation is very analogous to the U.S practice in its prevention of corporate misdeeds by the creation of sham/façade companies that aim only to profit the shareholders while resulting in the damages to third parties.

Nevertheless, it needs to be pointed out that the available instrument in the Armenian regulation can only be applied when the establishment of a commercial enterprise is proved to be without the intention to conduct entrepreneurial or banking activity.[78] The cases where the legal entity conducts certain activity while also pursuing fraudulent purposes is not regulated in the laws meaning that in order for the instrument to enable veil-piercing the legal entity must first be found to be not having any intention to conduct activities.

Moreover, the creditors have no right to apply directly to the court in order to recover their damages as only the Prosecutor is granted the power to exercise the defense of the right. The scarcity of the application of this instrument proves that the limited scope of the provision makes it very difficult to prove beyond reasonable doubt the fault of the controlling persons of the company and, hence, apply this provision. Also, despite the fact that the state has a positive obligation to discover the crimes and initiate the protection of the public and private sectors, the latter has only filed lawsuits to recover the damages caused by the controlling persons of the companies to the state for tax evasion.

[77] *Supra note 54*

[78] Supra note 68

CONCLUSION

It is indisputable that the legal personality/identity and the limited liability of the corporation plays a major impact in the field of business and, in particular, in the world of corporate law. The concept of the limited liability has been established to help business investors understand the risk they bear and the degree of its extent. If the limited liability principle was not existent, the investors would be exposed to unlimited liability if anything was to go wrong with the activities of the corporation. In short, the principle encourages the individuals to start businesses and knowing exactly what is the extent of their personal liability.

Nevertheless, many individuals, who have the decision-making powers in the corporation, abuse the protection that the limited liability grants to them. The principle has been misused by such individuals to gain personal benefits that are fraudulent and that cause damage to the corporation itself, creditors, citizens and the state. In this regard, a legal mechanism represented by corporate veil-piercing has been established to counter the cases where corporate misdeeds are committed by the dominant powers of the corporation.

As already illustrated in the paper, the practice of veil-piercing has been shaped internationally where the features of the doctrine have been proposed in various methods to

tackle the corporate misdeeds. Many states such as Russia and Germany have enabled the practice through relevant adjustments in the statutory laws that mainly address the cases of frauds and any other malicious actions of controlling members that aim to damage the third parties for their own benefit. Likewise, legislators of many states like the U.K have prescribed regulatory features (e.g. for bankruptcy misdeeds) in the relevant acts that grant the court with decision-making powers who, nevertheless, try to avoid disregarding the limited liability feature of the corporation.

Meanwhile, the legislations of some states do not propose solutions to tackle the issue of corporate misdeeds through corporate veil-piercing, yet the judiciary power constantly develops clear set of application rules for exceptional cases. The precedential judgements of the U.S judiciary have played a massive role in the development of the concept of veil-piercing as such. Namely, in number of judgements the U.S courts have established veil-piercing application theories (instrumentality and alter ego) that mastered the protection of the rights of creditors, tort victims and the state. Furthermore, the U.S practice has achieved new highs by shaping mechanisms for the availability of reverse-piercing.

Many Armenian practitioners argue that the veil-piercing doctrine is not expressed in the statutory laws, nevertheless, the regulations do exist in non-traditional forms. It has been illustrated in the paper that the veil-piercing regulations are present in the Law on Bankruptcy as well as the Criminal Code of the RA. The mechanisms in the name of intentional bankruptcy and fake entrepreneurial activity are effective in a way that they partially protect the rights of the creditors and the state who are caused damages as a result of intentional bankruptcy instructed by the controlling members of the bankrupted company. In addition, the provisions also address the issue of fraudulent purposes of controlling members who create sham/façade companies for their personal profit.

Nonetheless, there are certain issues that the available features of veil-piercing have, which limits the effectiveness of the latter. In particular, there are many issues with respect to the instrument of intentional bankruptcy and its interpretation by the CC such as (a) the filing of the claim on intentional bankruptcy by the administrator only; (b) the jurisdictional disputes between the different courts; (c) the limitation of the state to exercise the right to defense when intentional bankruptcy is at issue; (d) unclear addressing of corporate misdeeds

to be regarded; and (e) inadequate protection of the rights of minor creditors.[79] The presence of such issues in the regulation also leads to the current scarcity of judiciary practices and, thus, no progression of the doctrine of veil-piercing is present. The above-named factors accompanied with the conservative behavior of the Armenian courts towards the development of the veil-piercing doctrine leads to the growing number of unresolved corporate misdeeds and non-recovery of damages.

RECOMMENDATIONS

The following recommendations for better effectiveness of tackling corporate misdeeds in Armenia are given:

- To interpret Article 8 of the Law on Bankruptcy and Article 193 of the Criminal Code of RA in a way to grant the creditors as well as the state authorities the right to file a claim on joint liability of controlling members of the company on the ground of intentional bankruptcy[80];
- To examine the issue of intentional bankruptcy within the bankruptcy proceedings;
- To define/lay down the corporate misdeeds which may lead to the pierce of corporate veil;
- To implement relevant U.S practices of instrumentality and alter ego theories in the Armenian reality which do not contradict the statutory laws;

[79] Minor creditors shall mean the creditors whose damages do not exceed the large damage amount (1,000$) as provided by the Criminal Code of RA

[80] The burden of proof on the fraudulent intentions of bankruptcy shall lie upon the claimants.

- To address the rights of minor creditors whose damages remain unrecovered when intentional bankruptcy is in place;

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