Subsidiary Liability of Controlling Persons of Industrial Enterprises: Main Legal Conflicts

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Abstract. This work describes specific features of applying the institute of subsidiary liability of controlling persons of the enterprise. Creditors who have claims of non-fulfillment of obligations have been given the opportunity to pursue unlimited civil law actions against persons that are not directly related to them, which creates a certain imbalance and hinders the legitimate interests of other participants in the legal relations under consideration, in particular, the interests of managers. This research is aimed at studying the state and practice of applying the institute of subsidiary liability of controlling persons at enterprises and the doctrine of "removing the corporate veil" in Russia using methods of system and comparative analysis. The conducted research allowed us to establish a significant discrepancy between the Russian and international practices of applying the doctrine of "removing the corporate veil", and the presence of a clear imbalance in favor of creditors. As a result, it is concluded that there is a need for detailed regulation in the relevant legislation of terms and procedures for applying subsidiary liability of controlling persons at enterprises. The methodology of the research comprises historical, comparative, formal-legal and functional methods, systemic approach.

Keywords: Bankruptcy · Controlling persons · Doctrine of "removing the corporate veil" · Liability of controlling persons · Subsidiary liability

1 Introduction

One of the most effective methods of protecting rights of participants in economic relations is to create an effective consistent legal framework that excludes the possibility of double interpretation or abuse of definitions used in the law. Subsidiary liability is a key institution that ensures a balance between rights and obligations of creditors and a debtor. Recently, there has been quite a lively debate about the responsibility of controlling persons of the debtor, which include the parent companies, directorate, top management, members of the management board, majority shareholders, as well as group members who actually manage the company [7–9, 14, 15].

In the foreign scientific literature and practice, the doctrine of "removing the corporate veil" is widely used, which assumes the existence of "alterego" of the enterprise in the face of shareholders or other controlling persons at the enterprise as interested

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ones in the implementation and satisfaction of their personal self-interest through the enterprise activities and avoiding responsibility [2, 17].

The doctrine of "removing the corporate veil" was practically inapplicable to the corporate legal landscape of Russia in the 1990s and 2000s. Representatives of the business community learned about the owners of entire sectors of the economy through the press to the extent that they themselves desired it. Tens of thousands of offshore companies formally owned businesses in the Russian Federation. Many of them had quite an "overseas facade", were headed by Western managers, but de facto and de jure control belonged through trusts to domestic businessmen. The largest jurisdiction from which investments were directed to the Russian economy was small Cyprus with a population of 790 thousand people. The legal directors signed all the title documents. The most popular legal product of foreign consultants was the support of transactions, business purchases, structured under English law and subject to the jurisdiction of a foreign arbitration tribunal. Such constantly cultivated constructions provided two fundamental things: invulnerability of investors, which implied the confidentiality of asset ownership; the best opportunities for raising funds through banks, issuing shares, bonds, and large-scale long-term development.

The designated system was an adaptation to the hegemony of large international banking groups (from the United Kingdom and the United States) with unlimited financial resources, which is the personification of the movement of world money. Credit institutions participated in major projects and determined the contractual structures and names of the consultants involved. Accordingly, the market for legal services was built with a dominant presence of Anglo-Saxon firms in all countries – recipient of investment. It was not realistic to bring controlling persons to justice, in the case of bankruptcy because of ruinous operations that reduce the real value of the participation interest. Rules on the liability of actual managers and owners of legal entities existed in the 1990s, but in Russian legal practice, this institution, despite its existence, was applied only at the end of 2000. For many years, these institutions did not work, and the requirements were not met, although they were repeatedly reviewed. The reason for this is the passivity of courts requiring proof of causation, actual influence, control, etc.

However, the active use of this institution has created a number of new legal problems. Despite repeated assertions in the Russian legal literature that subsidiary liability should be exceptional and extraordinary, it has become a major segment of dispute resolution practice [10].

This legal trend seems to lead gradually or immediately to rethinking the institution of a legal entity as independently responsible for all its assets, as a separate unit in the sense that it does not shift the property burden on the founders and other persons, including its managers. But today, the existing institution of subsidiary liability of controlling persons of enterprises cannot be considered as satisfactory and providing a balance of interests of all participants, because of the imperfection and outright contradiction of legislative acts regulating the bankruptcy procedure.

2 Methodology

The research methodology includes historical, comparative, formal-legal and functional methods, and a systematic approach. When processing the actual material, traditional scientific methods such as dialectical, logical, scientific generalization, content analysis, comparative analysis, synthesis, source studies, etc. were used. The use of these methods allowed us to ensure the validity of the research results, theoretical and practical conclusions, and developed proposals.

3 Results

The origins of problems with subsidiary liability were legal barriers laid down in Paragraph 2 of Article 56 of the Civil Code of the Russian Federation, which presupposes the exclusion of mutual responsibility of the founder (participant) of a legal entity or the owner of its property and the legal entity itself for obligations [3].

This important principle allows you to take risks without incurring liability if financial investments were unsuccessful so much that, having assumed obligations, the created entity could not pay or repay them at the expense of its profits and current earnings. This is captured in the Roman formula *si quid universitati debetur singulis non debetur, nec quod debet universitas singuli debent* (what belongs to the Corporation doesn't belong to its individual members, or: what the Corporation owes, its individual members do not owe).

This canon has been based since the 16th century on the desire of the business community, which has always had levers of influence over the government and can create organizations characterized as "associations of capital", put into circulation surplus funds while being in formal financial security [1, 6].

Reputation, trust in the organization, and its "credit" were measured to a greater extent by two factors: ownership, as well as the prospects of the business idea for which it was created; and to a lesser extent by people behind it, since it is clear that if the project fails, its creators will not be responsible [16].

Paragraph 3 of Article 15 of the civil legislation of the USSR and the republics provided that in case of bankruptcy (insolvency) of a legal entity as a result of unlawful actions of the owner, insufficient funds and its property to meet the creditors' claims, the owner bears responsibility for obligations of the legal entity.

Nowadays, similar provisions are contained in Article 53.1 of the Civil Code of the Russian Federation, Paragraph 1 of which establishes the obligation to compensate for losses caused to an organization by requiring (1) a person authorized to act on its behalf, (2) members of collegial management bodies, (3) a person that had the actual ability to determine actions of the legal entity, as well as to give instructions [3].

It is important to note that now the responsibility of controlling persons comes for bad faith and unreasonableness (indīligentia et insapientia), while most authors firmly believe that these important legal categories replace guilt [11, 12]. For example, a real manager, having issued loans to non-operating organizations on the eve of bankruptcy proceedings, goes abroad in order to obtain permanent residence there. As a result, middle managers are also subject to criminal prosecution: members of the credit

committee, accountants, lawyers who make contracts and are not at the top of the hierarchy of labor relations, receive salaries, and so on. The inevitable plot in such a situation is to open a bankruptcy case and direct a group of individuals to full repayment of all creditors' claims. There is a curious phenomenon of group responsibility. The involved circle of allegedly involved citizens begins to testify or give evidence against each other in order to protect themselves from strict liability. The prescribed procedure for establishing a real imbalance between the assets forming the bankruptcy estate and the liabilities provides an incentive for a throwaway sale of assets, the implementation of which is realistic and not time-consuming. Therefore, in Russia, debts to creditors are never repaid in full, or only in a percentage.

4 Discussion

It is argued that failure to satisfy the claims of the company's creditors because of harm to their rights should result in tort liability in accordance with Chapter 59 of the Civil Code of the Russian Federation, as well as for violation of corporate rights [3, 4]. There is, however, another point of view that considers subsidiary liability as non-contractual, but not tort [13]. The defendants compensating for losses, in this case – causing harm and damage to property, in the true sense of the word, did not commit it. So far, the prevailing view is of direct tort liability in indirect claims and special subsidiary liability when controlling persons have caused the organization to lose its full functioning.

We assert that these legal institutions are an expression of the consistent implementation of the principle of full compensation and restoration of subjective rights, and in terms of the imposition of damages, legal claims are doctrinally unified.

Creditors in so-called subsidiary liability and participants in indirect claims lose not so much property as the value of a subjective right. Controlling persons become obligated to restore it only if they are involved and behave culpably. This situation should be regulated by Article 15 of the Civil Code, but in any case not by Chapter 59 of the same document on "direct" tort liability [3]. The tort liability construction is not appropriate for several reasons. Classic harm is a legal action that creates an obligation to replace and correct things that are experiencing physical damage. If it is not present, the need to perform certain actions does not arise, because in the first place, it is unclear what to do. A creditor in bankruptcy has claims that do not change because of the insolvency of an insolvent legal entity. It is not the property that suffers, or so much the property in the form of things, etc., it is a subjective civil right, which is based on expectations of creditors that some actions will occur or will be performed, the claim is repaid, etc. Controlling person, and not the bankrupt, through the outward manifestation of guilt becomes a violator of the civil right that can give effect to Article 15 of the Civil Code and not the Chapter on torts, which should not be applied because the nature of the harm is not so [3].

5 Conclusions

In general, it should be noted that the doctrine of "removing the corporate veil" in Russia, because of the imperfection of the legal technology and the lack of established law enforcement practice, not only has not fully formed, but has transformed into something completely different from the basic idea underlying the Western doctrine. The doctrine, which has an extraordinary character, has become a tool for "influencing" the controlling persons of enterprises.

The Civil Code of the Russian Federation has secured mechanisms for insurance (in the broad sense of this word) of creditors, allowing them to request awards not only from debtors, offenders, but also from other persons, primarily accomplices, obligated to debts, liable by law, named alternative, subsidiary, joint addressees of claims, etc. [3]. These are tools that are increasingly introduced to strengthen the stability of turnover, the fair distribution of the burden of property and losses of persons who relied on law-abiding behavior, the imposition of the risk of loss on other subjects, the preservation of property and material status. The fundamental rule that the causer and no one else is responsible for causing damage has undergone a significant transformation. Since the 19th century, it has been supplemented by a provision on compensation for persons specifically named in the law: representatives, guardians, employers, etc.

But these cases do not end with the imposition of responsibility on an innocent person. Needs called to life contractual structures of insurance, the role of the employer and others, in which, regardless of the fame of the main debtor, who may be a secret, not found criminal, losses are compensated. For this reason, tort liability has a too narrow scope to cover and give a legal foundation to modern legal configurations of liability, for example, in bankruptcy, etc., since in the mass of episodes, the person who caused the damage should not be held as responsible one.

Just the identification of the guilty activities of controlling persons with the offence creates a destructive basis for collective responsibility, making it impossible to file a claim to each other because the extent of their unlawful roles is always different, and requirements of the controlling person, showed slight negligence to the deliberate offender, are possible only with full compensation for the harm, but not earlier (Article 1081 of the Civil Code).

According to Article 15 of the Civil Code of the Russian Federation, some individuals may have losses in the form of "expenses" that they "will have to bear". Article 15 of the Civil Code allows you to recover damages from the guilty party outside of contractual and tort relationships [3]. Unfortunately, the key laws already have adopted concepts that prevent the approval of this simple and understandable logic. For example, the following definition is used: "the transaction caused harm", etc. The result of this terminology is a provision that can make recovery of losses in the field of bankruptcy and in the corporate area unworkable.

The main purpose of the insolvency procedure is to create a bankruptcy estate by returning assets and challenging transactions. In practice, there is legal uncertainty and inconsistency in the actions of courts, as a result, legal activity in the field of insolvency has become the most unpredictable according to many practicing lawyers. The reality is

that money transfers are disputed as transactions for the purpose of restitution, and payments are awarded to non-participating individuals who may be part of "groups of controlling persons" and therefore jointly liable.

In our opinion, a detailed study and unified judicial enforcement practice of applying the mechanism of "removing the corporate veil" are necessary, following the example of foreign jurisdictions [5, 18], which will ultimately allow us to maintain a balance between applying new rules and preserving, without distorting the essence and form, the principle of limited liability of participants and shareholders for the obligations of legal entities.

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