ISSN: 2688-8653

Study on the Pass-through Theory of Shareholders' Rights in Parent Company

Chenji Fang

School of Qingdao University of Science and Technology, Qingdao, 266061, China

Abstract

The establishment of subsidiaries is an important means of company operation, but it is also often used as a way to circumvent the law. In practice, it often happens that the controlling shareholder of the parent company uses the independent personality of the wholly-owned subsidiary to transfer the assets of the parent company, resulting in damage to the rights and interests of the minority shareholders of the parent company. At this time, it is difficult for existing legal norms to protect the rights and interests of minority shareholders. Therefore, it is necessary to introduce the shareholder rights Pass-through Theory, so that the rights of the parent company's shareholders can be applied to the subsidiary company. Its theoretical basis is that the parent company's excessive control of the subsidiary company has essentially destroyed the independent legal personality of the subsidiary company, and the parent and subsidiary company's personalities are mixed. However, the application of the shareholder rights pass-through system must be based on three principles: the parent company forms excessive control over the subsidiary company, the subsidiary company constitutes substantially all assets of the parent company, and the occurrence of matters in the subsidiary company may affect the major interests of the parent company's shareholders.

Keywords

Parent and Subsidiary Company; Shareholder Rights Pass-through Theory; Independent Personality of the Company.

1. Questions

Corporate capital is very favored for circulation through the establishment of subsidiaries. In order to achieve profitability, companies are increasingly inclined to a diversified development strategy. For example, through the development of upstream and downstream markets to ensure the continuous and stable supply of raw materials; to invest in the establishment of technology research and development centers to enhance core competitiveness and so on. The characteristic of the subsidiary company to independently assume civil liability enables the parent company to obtain scale effect and at the same time to diversify the operating risk, so it is favored by many investors. However, it should be noted that subsidiaries are often used as a tool to evade the law, and controlling shareholders often use the independent legal personality granted to wholly-owned subsidiaries by company law to infringe on the legitimate rights and interests of minority shareholders of the parent company.

Infringement on small and medium shareholders is often reflected in the transfer of assets of the parent company by the controlling shareholder using the independent personality of the wholly-owned subsidiary. As far as the acquisition of major assets of a limited liability company is concerned, the Company Law clearly stipulates that it is a matter for voting at the general meeting of shareholders . In this case, minority shareholders can use the system of dissenting shareholders' repurchase request set up in Article 75 of the Company Law to safeguard their own interests. However, matters related to the establishment of a wholly-owned subsidiary are

ISSN: 2688-8653

not subject to voting at the general meeting of shareholders as stipulated by the Company Law. If the articles of association of the company do not specifically provide for this, the parent company can first invest significant assets to establish a wholly-owned subsidiary, and then A wholly-owned subsidiary completely controlled by the parent company's board of directors can sell assets, which can bypass the shareholders' meeting to dispose of the parent company's major assets. At this time , the right of dissenting shareholders' repurchase request is in trouble and has nowhere to exercise.

2. Dilemma in Practice

2.1. Shareholders' Right to Know Cannot Penetrate the Veil of Subsidiary Companies

There is a close control relationship between the wholly-owned subsidiary and the parent company. The former often follows the instructions of the parent company's board of directors. It can be said that the parent company controls the board of directors of the subsidiary. It is a sign of the parent-subsidiary relationship. [1] According to the provisions of Article 33 of Company Law, the right to know that shareholders enjoy in my country is limited by the company's independent personality, and the scope of shareholders' right to know is limited to the company where they belong. Furthermore, if the parent company uses various acts carried out by the wholly-owned subsidiary to infringe on the rights and interests of shareholders , and the evidence materials that can prove the infringement fall within the scope of the subsidiary's right to know , the board of directors or the controlling shareholder of the parent company will no longer be subject to the Article 33 of Company Law. Precisely because of the barrier of the independent personality theory of the company, even if the shareholders with damaged rights exercise the right to know in accordance with Article 33 of the Company Law, the radiation force cannot penetrate the two veils of the parent company and the subsidiary company to reach the various documents within the scope of the subsidiary company, and their interests are still unmaintained. The reason for this is that the court 's cautiousness has its own reasons - the parent and subsidiary companies are divided into different subjects, and the law alone protects the company's trade secrets, which is enough to exclude the peeping of the parent company's shareholders.

2.2. Difficulties in Applying the Provisions on Abuse of Shareholder Power

From the legal point of view, if there is sufficient evidence to prove that the controlling shareholder or senior executives abuse their power, minority shareholders can completely seek the prohibition of the abuse of shareholders' rights in Article 20 of the Company Law or the operator's liability clause in Article 148. get compensation. However, this is not the case.

In practice, the above two clauses have disadvantages such as low efficiency and great uncertainty. Needless to say, the weak position of minority shareholders in the process of obtaining evidence, in addition, if it cannot be proved that the executives made major mistakes in the decision-making process, the subject of abusing their power can completely evade the company law by using the unavoidable business risk as a defense. restricted by the above rules . In addition, even if the existing evidence is sufficient to support the parent company's executives to bear the liability for damages to the wholly-owned subsidiary, the subject who has the right to file a shareholder representative lawsuit is not the parent company's shareholders , but the subsidiary's directors, supervisors or shareholders . At the same time, the calculation of the interests of damaged shareholders becomes more and more difficult after passing through the parent-subsidiary relationship . Therefore, the compensation that shareholders expect from the lawsuit is difficult to achieve.

ISSN: 2688-8653

2.3. Conflict of Laws and an Overemphasis on Procedural Justice Restrict Shareholders from Exercising Their Right of Avoidance

As mentioned above, wholly-owned subsidiaries are controlled by the parent company through the board of directors of the parent company in most cases. Unless something happens, parent company shareholders generally have no chance to directly influence wholly-owned subsidiaries. At this time, the only possible intersection between the two is when the parent company establishes a wholly-owned subsidiary through a resolution of the shareholders' meeting. In order to protect their own interests, minority shareholders can theoretically use Article 22 of the Company Law to stifle the attempt to establish a wholly-owned subsidiary, but the actual operation process is also full of difficulties.

Take the establishment of a wholly-owned subsidiary by a Sino-foreign joint venture as an example: the controlling shareholder often has a detached position in the shareholders' meeting, and it is not difficult for them to obtain one-half or even two-thirds of the voting rights. If the company's articles of association do not stipulate the proportion of votes on relevant matters, it is not common for the controlling shareholders of the company to directly violate the Company Law, the Detailed Rules for the Implementation of the Sino-Foreign Equity Joint Venture Law and other laws and administrative regulations, and the same is true for the directors of the company to make resolutions. Only in the voting procedure , there is a possibility of violating Article 7 of the "Interim Provisions on Domestic Investment of Foreign-invested Enterprises" , that is, the resolution to invest in the establishment of a subsidiary has not been unanimously approved by the board of directors of the parent company . However,the promulgation of this normative document is the Ministry of Foreign Trade and Economic Cooperation (which has been abolished, and the authority is now exercised by the Ministry of Commerce) and the State Administration for Industry and Commerce (organization integration, and the authority is now exercised by the State Administration for Market Regulation) . The departmental rules above are clearly not in the category of " violation of laws and administrative regulations" as stipulated in Article 22 of the Company Law . China's administrative organs have formulated a large number of normative legal documents of different levels, and the validity of regulations is only "reference" according to the expression of the Administrative Litigation Law, in other words, the court may or may not apply it . In this way, under the background of unclear litigation status of administrative regulations and lack of judicial review power for unconstitutional courts, it is difficult for courts to make convincing judgments by applying regulations [2]. Accordingly, when a director with an opposing opinion files a lawsuit to the court, claiming that the resolution to establish a subsidiary should be revoked without the unanimous consent of the board of directors , there is a high probability of encountering an embarrassing situation where the level of effectiveness of the regulations is too low and not recognized by the court .

In the case where the court recognizes the validity of the department's regulations , the request for revocation of the resolution is stilkl not necessarily supported by the court . According to the theory of company law, the resolution of the board of directors without unanimous consent is a procedural flaw . In order to avoid the huge negative economic benefits that may be generated by mechanical revocation, judges often believe that the procedural flaws of the resolution in a lesser situation do not necessarily lead to the revocation of the resolution. [3] In the early years, some scholars advocated the introduction of the "discretionary rejection system" from outside the territory, that is, giving judges greater discretion on this issue, and the judges should weigh the harm caused by the flaws of the resolution and the harm caused by the revocation of the resolution . This makes judges' pursuit of procedural justice blurred by economic considerations in adjudicating cases, and general procedural flaws cannot of course lead to the revocation of resolutions. This is even worse for the minority shareholders of the parent company - originally restricted by the exercise of the right of revocation, it was

ISSN: 2688-8653

impossible to file a shareholder revocation right lawsuit against the resolution of the subsidiary, and now even the resolution to revoke the parent company has the risk of being directly rejected due to the small number of shares.

3. Theoretical Legitimacy of Pass-through Theory

Independence of corporate personality and limited liability of shareholders are the two cornerstones of modern company law. The company's independent personality is the "veil" that separates the company and its investors. From the date of its establishment, the company is independent of its shareholders and can conduct external business activities in its own name, manage internally, and independently assume responsibility. The biggest obstacle to the passage of shareholder rights is to break through the personality independence between the parent company and the subsidiary company. Do we have enough reasons to affirm its legitimacy?

From the appearance point of view, the independent personality of the company depends on the company owning independent property and being able to undertake independent responsibilities on this basis. However, the reason why the law recognizes the company as having an independent legal personality and separates it from the shareholders behind it is that the key and essence of it is that the company has the ability to express its will independently. The value of modern corporate capital credit is weakening day by day, and the company's independent personality essentially depends on the independence of the company's intentions . [4] In other words, to deny the independent personality of the company, it is necessary to prove that the company has lost the ability to express its will independently, which is exactly in line with the theory of piercing the corporate veil . The company's will is generally expressed in the form of a resolution of the shareholders' meeting or a resolution of the board of directors. On the one hand, the expression of the company's intention can reflect the will of the members of the company's organs ; on the other hand, the independent intention of the company is not a simple collection of the wills of the members of the company's organs , it is based on the balance of interests based on the joint consultation and mutual game of all members participating in the resolution . As a result , it has an abstract meaning that goes beyond the individual members of the corporate body. If the company cannot form and express its independent will based on the governance structure, the independent personality of the company will cease to exist. Therefore, it is particularly important to ensure the formation of the company's independent will, so that it will not be interfered by the personal will of the members of the company's organs.

However, when there is a close relationship between the parent and subsidiary, the independent personality of the subsidiary is often in a state of substantial destruction because its ability to independently express its intention is suspended by the parent company. The reason is not difficult to understand. The original intention of the parent company to set up a subsidiary is to better realize its own interests. Taking this as a starting point, the parent company often regards obedience as the main criterion when appointing the directors, supervisors and executives of the latter . Decisions are made for the benefit of the parent company for its derivatives . When the parent company's excessive control over the subsidiary company results that the latter loses the ability of expressing itself independently , and then becomes a tool and vassal of the parent company, the independent personality of the subsidiary company will completely cease to exist . When such a situation occurs , the independent personalities of the subsidiary company ceases to exist , the legal personality of the subsidiary company has been absorbed by the parent company to a certain extent, and confusion has actually occurred between the parent company and the subsidiary company. At this time, if the law still insists that the parent company and the subsidiary company have independent personalities, it will help the misfortune . In order to pursue illegitimate interests, the

ISSN: 2688-8653

controlling shareholder of the parent company will implement actions that directly or indirectly harm the interests of other shareholders of the parent company.

Accordingly, the independent legal personality system, which is the core theory of the corporate system, has begun to be used improperly in the increasingly complex corporate relationship . Faced with the reality that the independent personality of the subsidiary company is absorbed by the parent company under certain circumstances, it is necessary for the law to place substance over form based on practical needs, transcending the rational understanding of the company's legal person nature and form, and learning from the company's legal person personality denial system. In this case, the parent and subsidiary companies are regarded as the same legal personality, so as to realize the substantial justice of the corporate personality. In the case that the personality independence of the subsidiary has been destroyed, we still adhere to the personality independence of the company's form, and do not recognize the identity of the parent company and the subsidiary personality, the subsidiary will become a tool to empty the shareholders' rights and interests of the parent company, and the authority of the company's independent personality will be shaken rather than strengthened. Therefore, it is necessary to confirm the mix of the legal personality of the parent and subsidiary companies under certain circumstances, so as to prevent the controlling shareholder of the parent company from using the company's independent personality to infringe the rights of other shareholders of the parent company. On this basis, it should be affirmed that the legal rights of the parent company's shareholders directly apply to the subsidiary company. The purpose of shareholder rights pass-through theory is to correct the imbalance of rights allocation among the stakeholders of the company caused by the "alienation" of the company's independent personality, so that the company's independent personality always runs along the track of substantive justice.

4. Applicable Conditions of Pass-through Theory

It must be noted that the pass-through theory should be an exception rather than a principle of company law. The fundamental purpose of this system is not to deny the independent personalities of parent and subsidiary companies, but to make special arrangements and protection for minority shareholders based on the balance of interests. Therefore, the passing of shareholder rights can only be the passing of specific powers in individual cases, rather than the passing of shareholders' rights in a general sense. Specific shareholder rights such as the right to know and the right to double-representative action are not abstract shareholder rights. In order to prevent the parent company's shareholders from abusing shareholder rights pass-through theory, avoid uncontrollable impact on the company's independent personality theory, and endanger the existing market economic order, the applicable conditions for shareholder rights traversal must be strictly limited.

4.1. Excessive Control of the Parent Company Over the Subsidiary

As discussed above, the key to judging whether a subsidiary is independent in personality lies in whether it can do an independent expression. Only when the parent company exerts excessive control over the subsidiary under the control of the controlling shareholder to the extent that it infringes the independent will of the subsidiary, and the independent personality of the subsidiary is damaged, it is necessary to apply shareholder rights pass-through theory. Therefore, the first thing to do is to judge the "degree" of the so-called excessive control of the parent company over the subsidiary company. The author believes that two steps are needed to judge whether there is excessive control. The first is that the parent company has the status quo of controlling subsidiaries, that is, to achieve a kind of "actual control", but this does not necessarily lead to excessive control. Excessive control can only result if improper interference is implemented on the basis.

Some scholars believe that if the parent company can decide the election and replacement of directors of subsidiaries, it can be identified as actual control [5]. Given the complexity of corporate governance structures , a single measure of control is not sufficient. Other scholars examine whether the subsidiary has been actual control based on factors such as shareholding ratio, voting rights, or controlling influence on company management, policies, and a certain transaction or behavior of the company. [6] This multi-factor comprehensive judgment perspective is worthy of recognition. In addition, the number and positions of directors or executives jointly owned by the parent company and subsidiaries also need to be included in the measurement.

However, the actual control has to evolve into excessive control, and there is also a link in the process, that is, the independent personality of the subsidiary is destroyed, and the ability to express itself independently is lost. The mixed legal personality of the parent and subsidiary companies is a necessary condition for the pass-through of shareholder rights. If the parent company only controls the subsidiary company, but the subsidiary company can still form and express its independent will through its corporate organs, there is no need for shareholder rights to pass through . As long as a wholly-owned subsidiary can still form an independent will, it should still respect its independent personality and cannot apply for pass-through of shareholder rights. There are two situations in which the subsidiary loses its independence of expressing its will: First, the parent company completely controls the subsidiary's shareholders' meeting, and the will of the subsidiary's shareholders' meeting is the will of the parent company; second, all or most directors of the subsidiary company And executives are selected or appointed by the parent company, and the board of directors and executives of subsidiaries make decisions entirely based on the will of the parent company.

4.2. Subsidiaries Constitute Substantially All Assets of the Parent Company

From the perspective of extraterritorial rules, the voting rights pass-through rules adopted by the corporate laws of some states in the United States require that the sale of major assets of a subsidiary should be regarded as a sale of major assets of the parent company only if the subsidiary substantially constitutes all the assets of the parent company. The voting rights of shareholders of the parent company can be passed through. [4] When the parent company is a pure shareholding platform, the assets and business resources of the "parent-subsidiary complex" are mostly concentrated in the subsidiary. From the perspective of a "parent-subsidiary complex", the subsidiary actually holds substantially all the assets of the complex, so it is also referred to as an "economically dominant subsidiary". At this time, the operation and management of the subsidiary will have a significant impact on the shareholders of the parent company, which is almost equal to the impact of the parent company's management on its shareholders. Only when the subsidiary constitutes substantially all the assets of the parent company, the subsidiary company has the same importance as the parent company, and the operation and management of the subsidiary company will have a significant impact on the vital interests of the parent company's shareholders.

"Economically dominant subsidiary" may arise from the establishment of the parent company with its substantially all assets, or it may arise from the transfer of substantially all assets from the parent company to the subsidiary after the establishment of the subsidiary. Judging from the experience of judicial practice in the United States, when defining whether a subsidiary constitutes "substantially all assets" of the parent company, some courts rely on quantitative factors, especially the proportion of the subsidiary in the parent company's total assets; some courts are more focused on considering the subsidiary Whether the assets of the company are essential to the operation of the parent company in nature , if the assets of the subsidiary company have a significant impact on the existence and business purpose of the parent company, such as the transaction of the assets of the subsidiary company will interfere with the

integrity of the parent company and damage the parent company's ability to continue going concern, the subsidiary's assets will be considered critical to the parent company in nature. It goes without saying that if the assets of the subsidiary are all of the parent's operating assets, or if the subsidiary's assets are the only revenue-generating assets of the parent , then the subsidiary must be critical in nature to the parent-subsidiary complex . Only when all these factors are taken into account can the court decide whether the subsidiary constitutes substantially all of the assets of the parent company.

4.3. The Occurrence of Events in the Subsidiary that May Affect the Material Interests of the Shareholders of the Parent Company

Under the control of the controlling shareholder, the parent company makes decisions to exercise excessive control over the subsidiary company, and the subsidiary company is substantially all assets of the parent company . At this point, minority shareholders of the parent company are in a precarious position. On the one hand, since the subsidiary is the main asset of the "parent-subsidiary complex", the subsidiary's behavior of disposing of its own interests will directly affect the interests of the parent company and then directly affect the interests of the parent company's shareholders; on the other hand the "control" of the parent company is in the hands of the controlling shareholder of the parent company, and the rights of other shareholders of the parent company cannot touch the subsidiary, making it difficult to directly participate in and effectively supervise the subsidiary's business decisions. The purpose of shareholder rights pass-through theory is to protect the parent company shareholders from the fundamental changes of the subsidiary company by giving the parent company shareholders the right to directly exercise shareholder rights to the subsidiary company. More specifically, to protect the reasonable expectations of parent company shareholders based on their investment behavior. Even if the subsidiary loses its independent personality under the excessive control of the parent company, but the affairs of the subsidiary do not affect the significant interests of the shareholders of the parent company, then there is no need for the shareholders of the parent company to pass the shareholder rights to the subsidiary.

Specifically, the occurrence of matters in the subsidiary that may affect the significant interests of the parent company's shareholders involves major changes or major transactions of the subsidiary, that is, the organizational structure, control structure and important economic interests of the subsidiary may be changed and affect the parent company's significant Equity or even causes fundamental changes in the parent company (such as amendments to the articles of association, division, merger, dissolution, major asset reorganization, formulation of surplus distribution plans, establishment of joint ventures or other forms of business alliances, capital increase, capital reduction, introduction of cumulative voting system, appoint or dismiss executives).

References

[1] Jianwen Wang, Dongdong Xi: Legal Regulations for Establishing Subsidiaries (Administration and Law), (2014) No. 5, p.101-106.

[2] Lishen Yu: The Status and Problems of Civil Law Sources of Administrative Regulations (Contemporary Law), (2005) No. 4, p.15-23.

[3] Shaokuan Ding: Research on the Effectiveness of the Defective Resolutions of the Shareholders' Meeting (Law) , (2009) No. 6, p.136-143.

[4] Jianwen Wang, Qingbai Sun: On the Institutional Construction of Shareholders' Rights Transcending (Jiangxi Social Sciences),Vol.40 (2020) No. 1, p.182-191.

[5] Jianwen Wang: On the Application of the Temasek Board of Directors System in the Reform of China's Commercial State-owned Companies (Contemporary Law), Vol. 32 (2018) No. 3, p.60-67.

[6] Yanjing Chen: Determination of the Elements of the Preservation of Corporate Resolutions , (Contemporary Law), Vol.33(2019)No. 5 , p.37-45.