

# The Misunderstanding between Legal Person and Limited Liability of Investors in Chinese Civil Law

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**Abstract:** In China's newly enacted General Principles of Civil Law, some new content is added: firstly, the legal person system is much more advanced; secondly, a new type of civil subject is added, namely the unincorporated organization, which transform the dual-type civil subjects system - legal person and natural person - into a ternary one, which seems to be a big change in China's civil law. However, when looking carefully into the content of that part, one of the crucial articles is art.108, according to which, most clauses in this legislative document designed for legal persons are applicable to unincorporated organizations. Since both of them are legally artificial, and apply to almost the same legal rules, then the necessity and legitimacy to add this new type civil subject is worth of rethinking. In order to figure out the answer, the author make a comparison between these two kinds of civil subjects. What comes to the author is that the essential distinction between them is that their equity investors undertake different form of liability concerning the artificial subjects' debt: the equity investor, namely the shareholders, of a legal person undertakes limited liability towards the debt of that subject, while for that of unincorporated ones, its investors shall undertake unlimited liability. What's more, in China's law system, legal person equals shareholders' limited liability. In addition, this is the reason to treat unincorporated organizations as an independent type of civil subjects for its equity investor shall undertake unlimited liability. In order to figure out the relationship between legal person and shareholders' limited liability, it is necessary to retrospect the evolving of them. By analyzing their respective function in civil and commercial activities, the correlation between them can be clarified and some misunderstanding will be dissolved. This is helpful for the social transformation in China today in order to deepen its reform. Thus, in the future civil and commercial legislation, the unique corresponding relationship between legal person and equity investors' limited liability might be regarded improper for social development.

## 1. Introduction

From the perspective of China's current bankruptcy law system, there is only a typical bankruptcy system for enterprises regarded as legal person. which is referred as enterprise bankruptcy law. According to art.2 of China's Bankruptcy Law for Enterprises, only enterprises with legal personality are allowed to invoke certain bankrupt procedure under this Law. This has drew the attention of Chinese academic circles for years and Chinese scholars held diversified opinions about how to change the current situation and finish building up the whole legislative framework of China's bankruptcy legal system that contains sufficient legal elements and procedures applicable for both enterprise with legal personality and other civil subjects, especially for individuals. Although this has been discussed for years, the bankruptcy legal framework still left almost unchanged. However, this paper does not mean to add another useless and meaningless opinion on the direct way towards the mansion of bankruptcy law, like the old saying, all roads lead to Roma, from the perspective of civil subject division, the writer believe some inspiring thoughts are worthy of expecting.

In Chapter 1 of the newly enacted General Principles of Civil Law (hereafter referred as "GPrinCL"), the system of civil subjects are reconstructed, a new type of subject is added, which is the non legal person organization, also referred as unincorporated organization..Compared to the previous General Provisions of Civil Law, only two types of civil subjects are regulated, natural person and legal person - both of them are remain in the GPrinCL. In GPrinCL, it regards

unincorporated organization as civil subject, and relevant legislative content concerning its status in litigation in the Civil Procedure Law are also timely modified. However, according to the content of traditional civil law, take the German Civil Law Code and the Civil Law Code in Taiwan as examples- both of them are regarded as the model of civil law and highly praised in mainland of China, civil subject are divided into two types: natural person and legal person. GPrinCL choose a different path from the traditional way regarding to the division of the civil subject. However, when looking into the essential legal nature of the other two types of civil subjects but natural person, there are almost no difference between them for they are both capable for civil rights, independently exercising rights and bearing obligations- both are the carriers of rights and obligations under civil law. If there is no substantial difference between them, the necessity of such division in the GPrinCL is questionable.

## **2. The Differences between Different Types of Chinese Civil Subjects**

### **2.1 The Types of Investor's Liability in Legal Person Entity and Unincorporated Organization**

The legislation expression concerning legal and non legal person entity in GPrinCL, according to the distinction between their respective establishment purpose for its investors or its shareholders. If the legal person will make a profit and distribute to its shareholders or investors, it shall be regarded as profitable legal person. Substantially this kind of legal person is almost equivalent to the relevant content of Company Law. Otherwise, if the investors are not intended to benefit from the legal person entity's profit, it is non-profit legal person. According to current legal framework, profit legal person includes the type of company in the current company law of China, which means limited liability companies, limited by Share Ltd and other enterprise legal persons. As for non-profit legal person, it covers public institutions, social organizations, foundations, social service institutions, etc for the purpose of public welfare and does not assign profits to the investors, the establishment or the members.

In contrast to the legal person entity, the typical unincorporated organizations include individual proprietorships, partnership enterprises, professional service institutions that do not have legal personality, so on and so forth. In specific analysis, the individual-owned enterprises based on Individual Proprietorship Enterprises Law, the founder uses its entire property on corporate debt and bear unlimited liability; in addition to the limited partnership, the partnership must have a general partner to bear unlimited joint and several liability under the Partnership Enterprise Law. The so-called professional service agencies, such as law firms, accounting firms, etc., which is a special general partnership providing the professional services, the partners still undertake unlimited liability. Based on the analysis of the investor's liability, it is clear that the members of these unincorporated organizations undertake unlimited liability for all the assets of the organization.

Therefore, whether the members of the civil subject bear limited liability or not is the key factor to the division of the two kinds of civil subjects: the legal person or the unincorporated organization, which is the most typical characteristic of GPrinCL.

### **2.2 The Theoretical Confusion: Legal Person Equals investor's Limited Liability**

In the classification of the civil subject in GPrinCL, the implied logical standard to identify a civil entity as legal persons or unincorporated organizations relies upon whether their members undertake limited liability or not to the legal burdens, such as its debt, of the fictional civil entity. Whether the shareholders or investors enjoy the preference of limited or unlimited liability is the fundamental boundary for the separation of legal person or the unincorporated organization, which forms the characteristics of the theoretical ternary classification of the civil subject in current Chinese civil law.

Legal person is equivalent to of its shareholders' or investors' limited liability while unincorporated organization is equivalent to members of the unlimited liability. However, theoretically speaking, the classical interpretation of legal person is quite different from this Chinese style proposition, that is to say, to a certain extent, legal persons equals their members bear the

limited liability is a misinterpret of legal person.

A lot of legal regime are borrowed from abroad to China during modern time, the formations of company is one of them. In the legislative documents, different forms were expressed, like unlimited company, joint liability company, joint stock liability partnership, etc. Past legislative acts indicate that shareholders is not for sure to undertake limited liability. Therefore, how come today's Company Law in China regards limited liability as the only privilege for shareholders? This paper will spread the illusion by following timeline.

### **3. The Revival of the Legal Person System Since 1978**

#### **3.1 Shareholders' Limited Liability of the Legal Person Became a Tool to Attract Foreign Funds**

The legal person system experienced an eventful fate in China. There were always foreign intervention or influence at each time of the establishment of legal person system, and the reason of every abolishment were the complex connection between the legal person system and the limited liability of the shareholder. On one hand, there may be no connection between them. Because the existence or none of the legal person system never influences the running of an enterprise. The initial motivation e of an enterprise to obtain the legal person's qualification through some factual conditions may just be the pursuit of administrative monopoly of the nation. On the other hand, as far as the shareholders' limited liability and unlimited liability are concerned, no matter whether the company is called limited or unlimited, when it comes to the property of the company, the liability for the company is no exception but always unlimited, which means this fictional entity shall undertake its obligation within the range of self-owned property. . The differentiation of the liability is in the terms of the shareholders' liability. Then how the limited liability of the shareholders and the unlimited liability of the limited corporation are connected? This is where the legal person system plays its role. as far as the author concerned, there exist disputes whether there are necessary connection between the legal person and shareholder. These disputes just prove that there are surely some special connections between them. For China, the legal person system is concerned about the international relations, not the internal problems.

Separating the managerial authority from property right of corporations is the foundational path to build up the modern enterprise. To achieve the goal of assuming sole responsibility for the corporation's profits and losses, forging an autonomous operation capacity, obtaining a relative independence and getting the capacity as a subject of law, the corporations has to become economic entities with the legal person capacity. Setting up the legal person system was an important issue for discussion in the Third Plenary Session of the 12th Central Committee in the year of 1984. It is an routine that once a consensus is reaching inside the party, it will be reflected in the area of legislation. Two years after the session, the relevant statement of legal person system in the Law of the People's Republic of China on Foreign-capital Enterprises is the best example. The eighth article in this law states that "An enterprise with foreign capital which meets the conditions for being considered a legal person under Chinese law shall acquire the status of a Chinese legal person, in accordance with the law." The Law of the People's Republic of China on Foreign-capital Enterprises opens the era of the wholly foreign-owned enterprises, which means the foreign investors could active as a shareholder of Chinese corporations. At that time, the cognition of the influence of the nationality of the shareholders on the corporate right of control is broken through and the extent of the openness is deeper.

#### **3.2 The Dependent Path of Establishing the Legal Person System of Private Enterprises**

In terms of the nature of the limited liability shareholders, private enterprises are limited liability companies. The statement of the shareholder limited liability system is the following: The investors is responsible to the company for its capital contribution, and the company is responsible for the debts of the company with all its assets. Such legal context inherits the statement about limited liability of shareholders in the period of the Republic of China. But it develops further, and makes it

clear that the limited liability company should assume unlimited liability. This is the first time of the appearance of such statement of dual-subject of the shareholder and company in Chinese legislative history.

There are quite a lot of similarities between the applications of the system of the limited liability of shareholders in the two kinds of limited liability companies, the limited liability company with foreign investment and the private enterprises. The shareholders in the two kinds of companies are both not state-owned, which makes the two kinds of companies fall into the control of the state investment policies and in the wake of the changes of the national need, the system interest towards the two kinds of companies will change correspondingly.

The reason of the reduction of the concerns and risks for the foreign investors and shareholders is the system of the limited liability of shareholders which limited liability companies rely on, rather than the contribution of the foreign-funded enterprises and private enterprises, which surely stimulate the development of the modern companies. Through the above reason, Chinese economy recovers in a high speed.

### **3.3 Reform of State -Owned Enterprises and Reference to the Property Isolation Function of Legal Person**

In the era of no 'legal person system' in enterprise, based on the requirements of the international cooperation, Chinese companies need to go out and search for opportunities to cooperate with foreign companies.. While once the dispute happened in the foreign country, because state-owned enterprises are not domestically recognized as an independent legal entity as legal person, all state-owned companies have been considered as one whole ownership entity and the state property regarded as the object of judicial execution in the foreign countries.

The establishment of legal person system, a clear scope of the corporate responsibility and property, so as to realize the segment of state-owned enterprises and the state public wealth, which is not only the necessity for foreign-funded enterprises, but also to the state-owned enterprises. Therefore, even in the domestic legal system the legal person has never been a problem, but since the reform and opening up, China must be integrated into the world, the legal person system will be inevitably required. From this point of view, it is a necessity for China to absorb state-owned companies to the realm of the legal person system in order to fight against indistinct judicial execution upon all state-owned enterprises' assets and the best beginning is the "foreign investment enterprise law". Therefore, for the goal to achieving, to separate the state-owned enterprises from each other and state-owned assets, and the shareholders, namely the government, of the state-owned enterprise transferred into the shareholders with limited liability is essential. The changing will get rid of the predicament of the confusion between the state responsibility and state responsibility, thus the state-owned enterprises treated in limited liability.

The ordinary content of limited liability of shareholders is embodied in the form of limited liability company, but in the 1993 Company Law", based on the model of 'limited liability company', a special company form, namely the state -owned company, is set up. The second chapter, third section of the 1993 Company Law made a special regulation of the state -owned company. The investment institution authorized by state or a department authorized by the state to invest the establishment of a limited liability company. The shareholder of the company is only one and in the form of the state ownership. It is similar to the 'one person company'.

### **3.4 The Enterprise and National Character of Legal Person Property Right**

The enterprise legal person system has become the main body of the company, and the property is the important characteristic of the legal person and the foundation of realizing its responsibility. In 1993, the company law explicitly put forward the concept of "legal person property right". However, the exact meaning of "legal person property right" needs to be clarified.

If the legislative expression of legal person property rights is the conception created to meet the corporatization of state-owned enterprises and intended to express the separation of the enterprise ownership and management, as a result, the state-owned assets of the company's property rights independent from the state shareholder itself, and as a result the administrative affiliation between

state-owned enterprise and the government in the planning economy era will be transferred to the investment relationship. By demanding the state to do so, the two roles played by the government in planning economy era - the identity of the governmental power and the identity of the shareholder or investor are separated. Therefore, when it comes to state-owned enterprises under company law, the state is no longer regarded as the symbol of public power, but just the investor of them. By doing so, the government at that time believed that it would be able to overcome the disadvantages from traditional mode of incorporation between the government and enterprises and the dependent of the enterprises. However, this re-stressed the argument that the ownership of state assets belong to the country, blurred the belonging of property rights between shareholders and the state-owned enterprises. The boundary between them exists logical confusion. Therefore, I believe, for promoting the restructuring of state-owned enterprises, 'corporate property rights' is too much concerned on the state and will be ruined.

#### **4. The Origin of the Legal Person System and the Joint Responsibility**

##### **4.1 The Evolution of the Legal Person System**

The general view of contemporary scholars is that the legal system originated in the period of ancient Rome. The community in the Roman society gradually gained certain legal status. However, groups of legally independent personality recognized by the Roman period are of a public nature or belonging to groups set up by the State and establishing of the civil or private groups is prohibited. It means that the property of the group with independent personality at that time is owned by the state and the property does not belong to the property of the group itself. The "Milan Edict" in 313AD should be regarded as the earliest legal recognition of the church property and will be included in the Roman law. The problem of the legal person's property was emerged at this point.

With the development of capital, a variety of legal activities engaged in a certain degree of independent property, and assume the risk and responsibility in a certain range. These entities was the prototype of the company nowadays, that is, the so-called "Corporate aggregate ". With the coming pace of the great navigational era and the colonial expansion of the capital, in the seventeenth century, many large oversea trading companies have been formed and through their legal personality, they carried out various activities. Different legal person systems have been formed in countries with their own national conditions. Whether in Napoleon Civil Code, German Civil Code or in the legal person of British Royal Charter and the Company Law and limited liability law, there existed similar legal person systems under different state laws..

##### **4.2 The Emergence and Development of the Joint Responsibility Form**

The Joint Responsibility Form refers to the responsibility composition of a group members, both with the limited and unlimited liability of the members. The group that produced this form in the early days was a partnership called "Commonda".

Regarding to the origin of this form, it is generally believed that it came from the entrusting business system of the Arabic business associates, it was closely related to the laws of the Islam Church in the Arab world that prohibited the lending money at interest. This business form functioned in the following way: the commission business relationship between a set of the amount of capital to determine the amount of investors with a limited liability and actual operators in charge of the whole business. The Arabs were deliberately pursued to evade the provisions of the Islamic church law in terms of the debt service. After the formation of this business practice, it gradually spread into the Byzantine Empire in the eighteenth century to the tenth century, including the southern port city of Italy, and thereafter gradually spread throughout the Mediterranean region.

In the late 11th century, with the advance of the great maritime era, the "Commonda" model was widely used in Italy, England and other European coastal states. This mode of operation to mobilize the funds were generally used for long-distance maritime trade, but not common in land trade. Each of the voyages should be contracted independently. And the adventurers, navigators, ship owners were responsible for the actual operation and undertook unlimited liability. The main financial

resources should be financed by the investors, who undertook the limited liability. After the voyage, they share the profits in proportion or agreed before. The form of each contract was gradually replaced by a certain period of the joint venture agreement, which evolved such a partnership gradually embarked on a stable development, and become the business organization form which similar to the traditional ordinary partnership form, namely, "Societas", each partner bears the unlimited responsibility.

This kind of "Commonda" form became the origin of the 'joint responsibility companies' and "hidden partnership" in the common law countries. The French Commercial Regulations of 1673 is the first statutory law to regulate the form of the two companies and the partners bear the limited liability, and this form provides a direct reference for the limited partnership legislation of the civil law country.

From the sources of the system development of the above two sections, the development of the legal person system is a kind of organization that gives the subject qualification similar to a natural person. As a result, it is eligible to enjoy its own property, that is, corporate property, and to exercise and assume responsibility independently in the name of a legal person. However, from the perspective of the "Comonda" model of the joint funding form, the limited liability and unlimited liability of investors are the way of investors' voluntary choice, which is irrelevant to the independent subject qualification of the organization after the investment. If entrusting the organization formed by the contribution itself with legal personality, and becoming a legal body, then this form is a legal person, as the problem of unlimited liability or limited liability of investors, nothing more than in the case of legal insolvency, the legal person make a declaration of the bankruptcy in the end and the investors continue to bear the debt liability.

Whether an artificial civil body is entitled to legal personality, or the investor has unlimited responsibility, those are two different issues. Even though the investor is assuming unlimited liability, and its funded organization has a legal personality, but the unlimited responsibility of the capital contribution of the capital is still belonging to the legal person's own property, there is no problem of the confusion of the unlimited investor property and legal person's property rights. On the contrary, it is unreasonable to presuppose that a group having the main qualification as a legal person equals that its investors' funding responsibility is limited to what it has funded to the artificial body.

## 5. Conclusion

The essential dispute between the ternary theory and the dualism theory of the civil subject is whether the unincorporated organization as the main body can be incorporated into the legal person system. This paper discusses the evolution of the legal system and the compatible of the investor's limited liability and unlimited liability, which in substance is to discuss the legal subjects' evolution from "ternary theory" to "dualism" in China legislation.

Through the analysis of the article, from the development trend of the whole legal person system in China, the mixed problem of the legal person system and the investor's limited liability is that under the background of the state-owned enterprise reform. The deviation of the understanding towards the legal person's property rights, combined with the state act as the main role in the development of a special historical period in the socialist market economy, in order to avoid the state act as an enterprise shareholders and bear the unlimited liability, which may leads to unexpected risk, the choice of corporate investors limited liability preferential treatment and the legislative tradition of legal subject are formed. Beside the legal person entity, there is another section focusing on the unincorporated organization, which bear the unlimited liability in GPrinCL.

With the development of society, various forms of organization are gradually forming into mature commercial practice, which requires various types of independent civil subjects. For example, in commercial activities of football clubs, large-scale commercial operation requires the football team to have a legal personality, but there is a division of the actual utilize of the team and the directly management of the investors. In the form of shares joint responsibility, the team operators bear unlimited liability and responsible for the daily operation while the investors share

the profits in accordance with the proportion of investment. In the case of a limited partnership, such as a law firm, if it is entitled to a legal personality, it is able to issue shares for fund-raising under company law and security law. Most importantly, if Chinese legal person system can cover the unlimited responsibility of investors, from the view of bankruptcy law, corporate insolvency law may be directly applicable to all legal subjects. In the case of unlimited investors, if a legal person's assets are insufficient to cover his debts, you can directly pursue to the unlimited liability of investors. It is the legislative foundation to the Chinese bankruptcy law, which will have a conversion from the legal person bankruptcy to the personal bankruptcy and even to the overall bankruptcy legislative in the future. The natural bankruptcy system will be more feasible in the Chinese legislative system without drastically modifying the Bankruptcy law.

Therefore, in the retrospection of the evolvement of Chinese corporate law in more than 30 years, the legal person system and the investors' limited liability should be clearly distinguished in legislative actions. From the author's point of view, since the GPrinCL is already enacted, therefore, in the forthcoming 'general provisions of business law' legislation, certain points illustrated in this paper is worthy of fully considering.

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